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AICPA Audit and Accounting Guide

AUDITS OF STATE AND LOCAL GOVERNMENTS (GASB 34 EDITION)

Issued September 1, 2002

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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AUDITS OF STATE AND LOCAL GOVERNMENTS (GASB 34 EDITION)

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AICPA Audit and Accounting Guide

**AUDITS OF
STATE AND LOCAL
GOVERNMENTS
(GASB 34 EDITION)**

Issued September 1, 2002

AICPA

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NOTICE TO READERS

This audit and accounting Guide presents recommendations of the AICPA State and Local Government Audit Guide Revision Task Force on the application of generally accepted auditing standards to audits of financial statements of state and local governments. This Guide also presents the Task Force's recommendations on and descriptions of financial accounting and reporting principles and practices for state and local governments. The AICPA Accounting Standards Executive Committee has found this Guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. The GAAP-related accounting provisions of this Guide have been cleared by the Governmental Accounting Standards Board (GASB). *AICPA members should be prepared to justify departures from the accounting guidance in this Guide.*

Auditing guidance included in an AICPA Audit and Accounting Guide is an interpretive publication pursuant to Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards*. Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board. The members of the Auditing Standards Board have found this Guide to be consistent with existing Statements on Auditing Standards.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

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The Task Force gratefully acknowledges the contributions made to the development, content, and writing of this Guide by Venita M. Wood, a consultant in governmental accounting and auditing issues. Her expertise and management of the project made this Guide possible.

This Guide reflects relevant guidance contained in authoritative pronouncements through May 2002:

GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*

GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*

GASB Technical Bulletin 2000-1, *Disclosures about Year 2000 Issues—a Rescission of Technical Bulletins 98-1 and 99-1*

SAS No. 96, *Audit Documentation*

SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*

GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, is effective in the same three phases provided for the implementation of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. (See Table 2.1 in Chapter 2, "Financial Reporting," of this Guide.) However, governments are not required to apply the provisions of GASB 38 at the same time that they apply the provisions of GASB Statement No. 34. That is, a government could early apply GASB Statement No. 34 without also having to early apply GASB Statement No. 38. This Guide, presuming that governments will simultaneously apply the provisions of GASB Statements No. 34 and No. 38, incorporates the provisions of GASB Statement No. 38. Governments that are required to implement GASB Statement No. 34 for financial statements for periods beginning after June 15, 2001 (phase 1 governments) are not required to implement certain provisions of GASB Statement No. 38 until financial statements for periods beginning after June 15, 2002, although earlier application is encouraged. This Guide identifies the requirements of GASB Statement No. 38 with that delayed effective date.

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide. Users may be able to obtain information about such subsequent pronouncements on the GASB's Web site at <http://www.gasb.org> and the AICPA's Web site at <http://www.aicpa.org>. In addition, the AICPA's annual Audit Risk Alert *State and Local Governmental Developments* summarizes the provisions of selected pronouncements.

See the Preface of this Guide for its effective date and a discussion of the continuing applicability of the 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*.

Preface

Purpose and Applicability of This Guide

In 1999, the Governmental Accounting Standards Board (GASB) issued standards to establish a new financial reporting model for all state and local governments, including public colleges and universities. Because of the significant changes in financial reporting resulting from those standards, the American Institute of Certified Public Accountants (AICPA) developed this Guide to help auditors understand the generally accepted accounting principles (GAAP) applicable to the financial statements of state and local governments and audit and report on those financial statements in accordance with generally accepted auditing standards (GAAS). This Guide is designed as a tool for auditors of governments of all sizes. The nature, timing, and extent of auditing procedures in a particular engagement are matters of professional judgment and will vary depending upon numerous factors, including the size of the entity and its organizational structure and internal control, materiality considerations, the auditor's assessment of risk, and applicable laws, regulations, and provisions of grants and contracts.

This Guide applies to all state and local governments as defined in Chapter 1, "Overview and Introduction." Certain other AICPA Audit and Accounting Guides also apply to audits of certain state and local governments, as discussed in Chapter 1.

Limitations and Coverage

This Guide is designed to provide guidance to auditors who are new to state and local governmental accounting and auditing as well as to auditors experienced in state and local governmental accounting and auditing. This Guide assumes that the auditor has expertise in accounting and auditing, in general, but not necessarily in the specialized accounting and auditing practices applicable to state and local governments. Therefore, the Guide concentrates on the accounting standards and auditing procedures that are unique to or significant for those governments. This Guide also is intended to be useful in providing accounting and financial reporting guidance to preparers of governmental financial statements. The guidance presented here is not all-inclusive; it is limited to certain matters that warrant special emphasis or that experience has indicated may be useful. Although this Guide does not incorporate, repeat, or summarize all authoritative pronouncements that apply to state and local governments, it does consider relevant guidance contained in authoritative pronouncements through those indicated in the Notice to Readers.

Authoritative pronouncements should be applied based on the effective dates in the pronouncements. The AICPA staff will make conforming changes to this Guide annually to incorporate relevant guidance in new accounting and auditing pronouncements. Users of this Guide should consider pronouncements issued after those listed in the Notice to Readers to consider their effect on state and local governments.

Effective Date

This Guide is effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply, or is required to apply, the provisions of GASB Statements No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, or No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and*

Universities.¹ (Chapters 2, “Financial Reporting,” and 7, “Capital Assets,” in the sections entitled “Transition to GASB Statement No. 34,” discuss the effective date provisions of GASB Statements No. 34 and 35.) Earlier application of this Guide is encouraged if a government issues financial statements that apply GASB Statements No. 34 or No. 35 after this Guide is issued. This Guide supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)* and subsequent editions of that Guide with conforming changes made by the AICPA staff, except as discussed in the following transition section.

Transition to GASB Statement No. 34

The 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)* remains effective for audits of state and local governments for which the auditor is not required to apply, or has not elected to early apply, the provisions of this Guide in accordance with its effective date provisions.

The following list includes some of the pronouncements of the GASB and its predecessor, the National Council on Governmental Accounting (NCGA), that made AICPA-originated accounting guidance applicable to certain state and local governments, even though that guidance was subsequently superseded by the AICPA.²

- NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, incorporated the provisions of AICPA Statement of Position (SOP) 77-2, *Accounting for Interfund Transfers of State and Local Governments*, and SOP 78-7, *Financial Accounting and Reporting by Hospitals Incorporated by a Governmental Unit*.
- GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, permitted those entities to use the accounting and financial reporting guidance recognized by the Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*.
- GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, permitted certain state and local governments to apply not-for-profit accounting and financial reporting principles by following SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*.

GASB Statements No. 34 and No. 35 now also supersede the AICPA-originated accounting guidance in the Guides and SOPs listed above. However, that AICPA-originated accounting guidance remains effective for affected state and local governments that have not yet implemented, and that are not yet required to implement, Statements No. 34 and No. 35.

¹ GASB Statement No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*, amends GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, to include public colleges and universities within its scope. This Guide’s references to the application of GASB Statement No. 34 also apply to the application of that standard under the provisions of GASB Statement No. 35.

² For example, the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* superseded the Industry Audit Guides referenced in the following listing as well as AICPA Statements of Position (SOPs) 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*. The Guides and SOPs in this listing are no longer available through the AICPA.

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Chapter 1

Overview and Introduction

Scope and Purpose

1.01 This Audit and Accounting Guide (Guide) applies to all state and local governments.^{1, 2, 3} Governmental organizations are subject to generally accepted accounting principles (GAAP) for state and local governments as described later in this chapter. Public corporations⁴ and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
- The potential for unilateral dissolution by a government with the net assets reverting to a government; or
- The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

1.02 Organizations are governmental or nongovernmental for accounting, financial reporting, and auditing purposes based solely on the application of the above criteria; other factors are not determinative. For example, the fact that an organization is incorporated as a not-for-profit organization and exempt from federal income taxation under the provisions of Section 501 of the

¹ Auditing and accounting matters associated with the federal government are not within the scope of this Guide. Throughout this Guide, state and local governments may be referred to using the terms *governments* or *governmental entities*.

² Certain component units do not meet the definition of a government contained in this paragraph and, consequently, accounting, financial reporting, and auditing matters associated with the separate financial statements of those component units are not within the scope of this Guide. However, accounting, financial reporting, and auditing matters associated with reporting component units, including nongovernmental component units, in a reporting entity's basic financial statements, required supplementary information (RSI), and supplementary information other than RSI (known as SI) are within the scope of this Guide. Chapter 3, "The Financial Reporting Entity" discusses the GASB standards for defining and reporting component units.

³ Other AICPA Audit and Accounting Guides also may be applicable to audits of certain governments. See paragraph 1.21.

⁴ *Black's Law Dictionary* defines a public corporation as: "An artificial person (e.g. [a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state." *Sharon Realty Co. v. Westlake, Ohio Com. Pl.*, 188 N.E.2d 318, 323, 25, O.O.2d 322. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. *York County Fair Ass'n v. South Carolina Tax Commission*, 249 S.C. 337, 154 S.E.2d 361, 362.

Internal Revenue Code is not a criterion in determining whether an entity is governmental or nongovernmental for accounting, financial reporting, and auditing purposes.

1.03 Although recognized Indian tribes may not meet the definition of governmental entities in paragraph 1.01, many use governmental accounting and financial reporting guidance to prepare their financial statements. A section of Chapter 12, “Special-Purpose and State Governments,” highlights the accounting, financial reporting, and auditing considerations relating to recognized Indian tribes.

1.04 There are over 87,000⁵ general- and special-purpose state and local governmental entities in the United States. *General-purpose governments* are governmental entities that provide a range of services, such as states, cities, counties, towns, and villages. Special-purpose governments are legally separate entities that perform only one activity or only a few activities. *Special-purpose governments* include, for example, cemetery districts, levee districts, assessment districts, drainage districts, school districts, utilities, hospitals or other health care organizations, public benefit corporations and authorities, public employee retirement systems (PERS), public colleges and universities, governmental external investment pools, and public entity risk pools.

1.05 An audit of a governmental entity may be conducted under four different groups of auditing standards or requirements:

- a. Generally accepted auditing standards (GAAS)
- b. The standards applicable to financial statement audits contained in the 1994 revision of *Government Auditing Standards*, as amended (also referred to as the Yellow Book), issued by the Comptroller General of the United States
- c. The requirements of the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*⁶
- d. Other auditing requirements, such as those required by a state oversight agency for audits of local governments

1.06 This Guide discusses in detail the requirements for a financial statement audit encompassed by GAAS. Under Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), this Guide is an interpretive publication.⁷ That is, this Guide provides guidance on the application of SASs in a governmental environment. This Guide also highlights the requirements

⁵ U.S. Bureau of the Census, *1997 Census of Governments: Volume 1, Government Organization*.

⁶ The first three groups of audit standards and requirements are cumulative and progressive. That is, *Government Auditing Standards* incorporates and adds requirements to GAAS, and the Single Audit Act incorporates and adds requirements to both *Government Auditing Standards* and GAAS.

⁷ SAS No. 95, *Generally Accepted Auditing Standards*, requires auditors to be aware of and consider interpretive publications applicable to the audit. An auditor who does not apply the auditing guidance included in an applicable interpretive publication should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance. SAS No. 95 is effective for audits of financial statements for periods beginning on or after December 31, 2001. Earlier application would be permitted.

for a financial statement audit encompassed by *Government Auditing Standards*, referring where appropriate to the detailed discussion of those standards in SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, which is included as Appendix D of this Guide. That SOP provides detailed guidance on audits of federal awards and the requirements of the Single Audit Act and OMB Circular A-133, including the requirements of *Government Auditing Standards*. Other auditing requirements are beyond the scope of GAAS and this Guide and generally are not discussed in this Guide. (See the further discussion of the four groups of auditing standards and requirements starting at paragraph 1.16.)

1.07 This Guide provides guidance for the audits of governmental financial statements that are prepared in conformity with GAAP⁸ and is based on pronouncements issued or cleared by the Governmental Accounting Standards Board (GASB). (See the following section for a discussion of GAAP for state and local governments.) This Guide does not establish new accounting principles, but does carry forward certain accounting guidance from the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*. That carried-forward guidance is consistent with, or has been modified to be consistent with, current GASB pronouncements, in particular the provisions of the financial reporting model established in GASB Statements No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*. That carried-forward guidance is listed in Appendix B, “Category B Guidance,” of this Guide.

1.08 The accounting and auditing guidance in this Guide may become superseded by standards issued since its publication. Therefore, when planning and conducting an audit of financial statements in accordance with GAAS, the auditor should refer to the most recent applicable pronouncements of authoritative standard-setting bodies, such as the GASB, the Financial Accounting Standards Board (FASB), and the Auditing Standards Board and the Accounting Standards Executive Committee (AcSEC) of the AICPA.

GAAP for State and Local Governments

1.09 Pursuant to Rule 203 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 203.01), the AICPA recognizes the GASB as the standard-setting authority for GAAP for state and local governments. To provide accounting and financial reporting guidance for governments, the GASB has issued various Statements and Interpretations, and its staff has issued various Technical Bulletins and Implementation Guides.

1.10 Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, as amended by SAS No. 91, *Federal GAAP Hierarchy* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), establishes a hierarchy of GAAP applicable to state and local governmental entities that indicates the level of authority of various sources. The application of GAAP for governmental financial statements is as follows:

⁸ Chapter 14, “Audit Reporting,” and Chapter 15, “Comprehensive Bases of Accounting Other Than Generally Accepted Accounting Principles” also discuss auditor’s reports on summary financial information (popular reports) and on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (OCBOA financial statements), respectively.

- a. Category (a), officially established accounting principles, consists of GASB Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations. GASB Statements and Interpretations are periodically incorporated into the GASB Codification.⁹
- b. Category (b) consists of GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA and cleared by the GASB,¹⁰ AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.
- c. Category (c) consists of the AICPA AcSEC Practice Bulletins, if specifically made applicable to state and local governmental entities and cleared by the GASB, as well as consensus positions of a group of accountants organized by the GASB that attempts to reach consensus positions on accounting issues applicable to state and local governmental entities.¹¹
- d. Category (d) includes implementation guides (Qs and As) published by the GASB staff, as well as practices that are widely recognized and prevalent in state and local government.¹²

1.11 SAS No. 69 states that, in the absence of a pronouncement covered by Rule 203 (that is, category (a) guidance) or another source of established accounting principles (that is, categories (b)–(d) guidance), the auditor of governmental financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example:

- GASB Concepts Statements
- FASB and AICPA pronouncements when not specifically made applicable to state and local governmental entities either by the GASB or by the organization issuing them

⁹ Two GASB publications, *Original Pronouncements* and *Codification of Governmental Accounting and Financial Reporting Standards* (Codification), provide authoritative accounting guidance for state and local governmental entities and are updated by the GASB as of June 30 each year. (**Transition note:** Until GASB Statement No. 34 becomes fully effective, the GASB is issuing two editions of *Original Pronouncements* and the Codification—a GASB Statement No. 34 edition and a non-GASB Statement No. 34 edition.) *Original Pronouncements* includes National Council on Governmental Accounting (NCGA) and GASB Statements and Interpretations and other materials in their original form, with indications of amended and interpreted standards. (GASB Statement No. 1, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*, continued in force certain pronouncements of the AICPA and the NCGA, the GASB's predecessor.) The Codification organizes currently effective governmental accounting financial reporting standards into topical areas. Those who prepare or audit governmental financial statements should obtain a current edition of *Original Pronouncements* or the Codification. This Guide refers to NCGA and GASB pronouncements. Readers can locate those references in the Codification by using its appendix, *Finding List of Original Pronouncements*, which shows where each paragraph of each original pronouncement may be found in the Codification.

¹⁰ The auditor should assume that such AICPA pronouncements specifically made applicable to state and local governments have been cleared by the GASB, unless the pronouncement indicates otherwise.

¹¹ The GASB has not organized such a group.

¹² A conclusion that a particular practice is widely recognized and prevalent is a matter of professional judgment by individual financial statement preparers and auditors. Other accounting literature, as discussed in paragraph 1.11, cannot appropriately assert to represent widely recognized and prevalent practices and, thus, category (d) guidance in whole or in part. Similarly, references in this Guide to common practices do not take the place of professional judgment about whether a practice is widely recognized and prevalent or elevate that practice from category (d) guidance.

- FASB Concepts Statements
- Federal Accounting Standards Advisory Board (FASAB) Statements, Interpretations, Technical Bulletins, and Concepts Statements
- AICPA Issues Papers
- International Accounting Standards of the International Accounting Standards Committee
- Pronouncements of other professional associations or regulatory agencies
- Technical Information Service Inquiries and Replies included in *AICPA Technical Practice Aids*
- Accounting textbooks, handbooks, and articles

The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, GASB Concepts Statements normally would be more influential than other sources in this category.

1.12 GASB pronouncements have made certain AICPA and FASB pronouncements specifically applicable to governmental entities. For example, GASB Statements No. 20, *Accounting and Financial Reporting by Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, and No. 34 require the application of certain pronouncements of the FASB and its predecessor standards-setting organizations issued before November 30, 1989, and permit the application of later FASB pronouncements in certain situations, as discussed in Chapter 2, “Financial Reporting.”

1.13 This Guide makes various references to implementation guides published by the GASB staff. As discussed in paragraph 1.10, those implementation guides are category (d) guidance in the hierarchy of GAAP applicable to state and local governments. GASB staff implementation guides have not been reviewed by AcSEC and references to their guidance in this Guide do not elevate that guidance to category (b) guidance. Further, the GASB’s clearance of this Guide does not elevate the guidance it contains from the implementation guides to category (b) guidance. Similarly, references in this Guide to discussions or examples in the nonauthoritative appendixes of GASB pronouncements or its staff’s implementation guides do not elevate that guidance from “other accounting literature.”

1.14 Rule 203 prohibits an auditor from expressing an unqualified opinion if the financial statements contain a material departure from accounting principles promulgated by a body designated by the AICPA Council to establish such principles (that is, category (a) guidance) unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 states that the application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows in conformity with GAAP. Nevertheless, Rule 203 provides for the possibility that the literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. In such a situation, Rule 203 requires the auditor’s report on the financial statements to describe the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement. (See paragraphs 14 and 15 of SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508.14 and .15].)

1.15 SAS No. 69 (AICPA, *Professional Standards*, vol. 1, AU sec. 411.07), states that if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles (that is, categories (b)–(d) guidance). If such an accounting principle is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (b) treatment over category (c)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances. Therefore, no description in the auditor’s report on the financial statements is required for the situations described in this paragraph, but the auditor should consider documenting such conclusions in the audit documentation.

Applicable Auditing Standards and Requirements

1.16 Audits of governmental financial statements should satisfy auditing standards established by the AICPA, which are the general, fieldwork, and reporting standards and the SASs. Audits of governmental financial statements also should consider applicable interpretative publications that provide recommendations on the application of the SASs—Audit and Accounting Guides, SOPs, and Auditing Interpretations.¹³ SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), is particularly relevant to auditors of state and local governments. SAS No. 74 states that if, during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal and contractual provisions. See Chapter 4, “Planning the Audit,” for a discussion about considering the requirements of SAS No. 74 while planning the audit.¹⁴

1.17 In addition to GAAS, auditors of state and local governmental entities also may need to comply with *Government Auditing Standards*. Those standards are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. For financial audits,¹⁵ *Government Auditing Standards* incorporates all AICPA audit standards for fieldwork and reporting, and its general standards are similar to those of the AICPA. It also contains additional general, fieldwork, and reporting standards and provides additional guidance in certain areas. *Government Auditing Standards* requirements and guidance relating to financial audits are

¹³ See footnote 7.

¹⁴ Auditors also may be engaged to provide attest services—an engagement to express a conclusion on subject matter, or an assertion about the subject matter, that is the responsibility of another party. Those engagements are conducted in accordance with the AICPA’s Statements on Standards for Attestation Engagements and are not within the scope of this Guide.

¹⁵ Besides financial audits, *Government Auditing Standards* also addresses performance audits. Financial audits and performance audits are defined in Chapter 2 of *Government Auditing Standards*.

discussed further in SOP 98-3 (Appendix D of this Guide), and its additional standards and guidance are outlined in paragraphs 3.8 and 3.9 and Tables 3.1 and 3.2 of that SOP.

1.18 The Single Audit Act imposes additional audit responsibilities on auditors of certain state and local governments that expend federal awards. The OMB is the federal agency that has primary responsibility for implementing the Single Audit Act, and OMB Circular A-133 sets forth audit requirements for single audits. A supporting OMB document, *OMB Circular A-133 Compliance Supplement*, which is updated annually, identifies the significant compliance requirements to be considered in single and certain program-specific audits. Audits under the provisions of the Single Audit Act and OMB Circular A-133 are discussed in SOP 98-3 in Appendix D of this Guide.

1.19 Before undertaking audits of governmental entities, or of specific governmental grants, programs, or contracts, auditors should be knowledgeable of the auditing requirements that affect the scope of the engagement, including those promulgated by state or local governments or federal agencies that have oversight authority over the government or are responsible for administering the specific grants, programs, or contracts.

1.20 AICPA Ethics Interpretation 501-3, "Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits," of ET Section 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.04), states:

If a member . . . undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, in addition to generally accepted auditing standards, he or she is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of Rule 501 of the AICPA Code of Professional Conduct, unless the auditor discloses in his or her report the fact that such requirements were not followed and the reason therefor.

Guidance in Other AICPA Audit Guides and Statements of Position

1.21 This Guide is not the only industry-specific AICPA Audit and Accounting Guide that auditors might have to consider when performing an audit of a governmental entity.¹⁶ Two other industry-specific guides include governmental entities in their scope and were cleared by the GASB. Those guides are *Audits of Property and Liability Insurance Companies* and *Health Care Organizations*. Therefore, certain accounting and financial reporting guidance in those guides constitutes category (b) guidance for the applicable governmental entities, and the auditing guidance in those guides also should be considered during an audit of those governmental entities. (See the further discussions concerning the application of this Guide to those governmental entities in the sections of Chapter 12 entitled "Public Entity Risk Pools" and "Hospitals and Other Health Care Providers.") In addition, SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit and State and Local Governmental Entities That Include Fund Raising*, includes governmental entities in its scope and was

¹⁶ Auditors also should consult the general AICPA Audit Guides, such as *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* and *Consideration of Internal Control in a Financial Statement Audit*, for practical guidance for applying the provisions of specific Statements on Auditing Standards.

cleared by the GASB and, thus, is category (b) accounting and financial reporting guidance for governmental entities. (That SOP is included as Appendix D in this Guide.)

1.22 Other AICPA Audit and Accounting Guides and SOPs may provide useful suggested auditing procedures if a governmental entity is in a specialized industry or has transactions addressed by those guides and SOPs, even though governmental entities are not included in their scope. Among those guides are *Audits of Casinos*, *Audits of Employee Benefit Plans*, *Audits of Investment Companies*, *Brokers and Dealers in Securities*, and *Not-for-Profit Organizations*, as well as *Financial Institutions*, a guide that the AICPA anticipates publishing, in late 2002, to combine and redraft chapters from the existing AICPA Guides for *Banks and Savings Institutions*, *Credit Unions*, and *Finance Companies*.

1.23 Although not reviewed by the GASB or made specifically applicable to governmental entities, the guides listed in paragraph 1.22 and AICPA SOPs other than SOP 98-2 also have accounting guidance that may be useful as “other accounting literature” in a particular situation, provided it does not conflict with or contradict other, higher categories of governmental GAAP. (See also the discussion in Chapter 2 on the applicability of certain post-November 30, 1989 AICPA pronouncements to enterprise funds and to the resulting reporting in the government-wide financial statements.)

Other Sources of Guidance

1.24 The following AICPA publications contain guidance that may be useful in conducting audits of governmental financial statements. Under SAS No. 95, these are “other auditing publications” and, although they might be useful, auditors are not required to consider them.¹⁷

- The AICPA issues an annual Audit Risk Alert, *State and Local Governmental Developments*, as a complement to this Guide. The Alert provides an overview of economic and industry conditions, regulatory developments, and recently issued accounting and auditing pronouncements that may affect audits of governmental entities. That Audit Risk Alert includes information about how to obtain many of the publications referred to in this Guide and a listing of useful Web sites. The AICPA also annually issues a general *Audit Risk Alert* and Audit Risk Alerts as complements to other Guides (such as some of the Guides mentioned in paragraphs 1.21 and 1.22) that may be useful in conducting audits of governmental financial statements.
- The AICPA has developed and is developing various publications to assist with financial statement audits of state and local governmental entities. *Understanding and Implementing GASB's New Financial Reporting Model—A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements, Revised Edition* digests the contents of GASB Statement No. 34 and includes observations on planning and implementation issues. The AICPA anticipates publishing, in late 2002, a single publication that includes both the GASB 34 and non-GASB 34 Editions of *Checklists and Illustrative Financial Statements for State and Local Governments*. That publication will provide checklists of GAAP-required disclosures

¹⁷ See footnote 7 for related information.

in governmental financial statements, notes to financial statements, and required supplementary information (RSI), among other things. The AICPA also is planning to soon issue a practice aid to discuss audits of governmental financial statements, with special focus on GASB Statement No. 34.¹⁸

Organization of This Guide

1.25 This Guide is organized as follows:

- Chapters 2, “Financial Reporting,” and 3, “The Financial Reporting Entity,” provide an overview of the accounting and financial reporting requirements for governments, including the activities and financial statements that should be included in their basic financial statements and the RSI that should accompany those financial statements.
- Chapter 4, “Planning the Audit,” provides guidance on various considerations relating to planning the audit, such as materiality, internal control, and compliance requirements that may affect the audit, and communications with the auditee.
- Chapters 5, “Cash, Investments, and Investment-Related Activity,” through 10, “Equity and Financial Statement Reconciliations,” discuss, for various accounts in the financial position and activity statements,¹⁹ the nature of the transactions; accounting and financial reporting considerations; and auditing considerations, including audit objectives, internal control features, and audit procedures.
- Chapter 11, “The Budget,” discusses the effect of a government’s budget on its activities, financial reporting, and audit. Chapter 12, “Special-Purpose and State Governments,” highlights accounting, financial reporting, and auditing considerations relating to special-purpose, Indian tribal, and state governments.
- Chapters 13, “Concluding the Audit,” and 14, “Audit Reporting,” present various considerations relating to finalizing the audit and the auditor’s reports on financial statements.
- Chapter 15, “Comprehensive Bases of Accounting Other Than Generally Accepted Accounting Principles,” discusses the financial statements and auditor’s reports on governmental financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP, which are referred to as OCBOA financial statements.
- Chapter 16, “Auditor Association with Municipal Securities Filings,” discusses the auditor’s association with a government’s official statements and continuing disclosure documents for debt issuances.

¹⁸ This practice aid is expected to contain many of the basic audit programs from the State and Local Government section of *Audit and Accounting Manual*, revised to incorporate the provisions of GASB Statement No. 34 and related pronouncements.

¹⁹ This Guide sometimes uses the term *financial position statements* in a generic manner to refer to one or more of the following—the government-wide statement of net assets, the governmental funds balance sheet, the proprietary funds statement of fund net assets or balance sheet, and the fiduciary funds statement of fiduciary net assets. This Guide sometimes uses the term *activity statements* in a generic manner to refer to one or more of the following—the government-wide statement of activities, the governmental funds statement of revenues, expenditures, and changes in fund balances, the proprietary funds statement of revenues, expenses, and changes in fund net assets or fund equity, and the fiduciary funds statement of changes in fiduciary net assets. Those financial statements are discussed in Chapter 2, “Financial Reporting.”

Sections on Transition to GASB Statement No. 34

1.26 Where applicable, this Guide includes a separate section at the end of various chapters or specially marked footnotes to discuss accounting and auditing considerations relating to the transition to the financial reporting model established by GASB Statement No. 34. Those transition sections and footnotes will be removed from this Guide as conforming changes when the provisions of GASB Statement No. 34 become fully effective.

Chapter 2

Financial Reporting

Introduction and Overview

2.01 Governments have unique requirements for financial reporting—that is, how they present information in their basic financial statements (including the notes to those financial statements) and required supplementary information (RSI). This chapter provides an overview of the basic financial statements and RSI required by Governmental Accounting Standards Board (GASB) standards and discusses certain auditing considerations relating to them. It also discusses in detail certain GASB standards and the supplementary information other than RSI, known as SI, that some governments present with their basic financial statements.¹ Other chapters in this Audit and Accounting Guide (Guide) provide additional details about the accounting, financial reporting, and auditing considerations for the basic financial statements and RSI.

Historical Perspective

2.02 The required structure and presentation of information in a government's basic financial statements is known as *the financial reporting model*. For many years, and most recently with the issuance in 1979 of National Council on Government Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, generally accepted accounting principles (GAAP) have required governments to present their financial statements using a funds structure. When it was created in 1984, the GASB agreed that, among other projects, it would reexamine the financial reporting model. Later, the GASB agreed also to consider the financial reporting model for public colleges and universities. The GASB's efforts resulted in the issuance in 1999 of GASB Statements No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*.

2.03 The nonauthoritative Basis for Conclusions of GASB Statement No. 34 explains the GASB's reasoning for the required financial presentation, which builds on the traditional, fund-based financial reporting model. Ultimately, the GASB believes that the financial reporting model required by GASB Statement No. 34 will provide more understandable and useful information to financial statement users within the context of two types of accountability—fiscal accountability and operational accountability. The GASB defines *fiscal accountability* as the responsibility of governments to justify that their actions in the current period have complied with public decisions concerning the raising and spending of public moneys in the short term. *Operational accountability* is governments' responsibility to report the extent to which they

¹ This Guide uses the term supplementary information (SI) to refer to supplementary information other than that required by the GASB (or, if applicable, the FASB), consistent with that usage in GASB standards.

have met their operating objectives efficiently and effectively, using all resources available for that purpose, and whether they can continue to meet their objectives for the foreseeable future.

Governmental Financial Statements

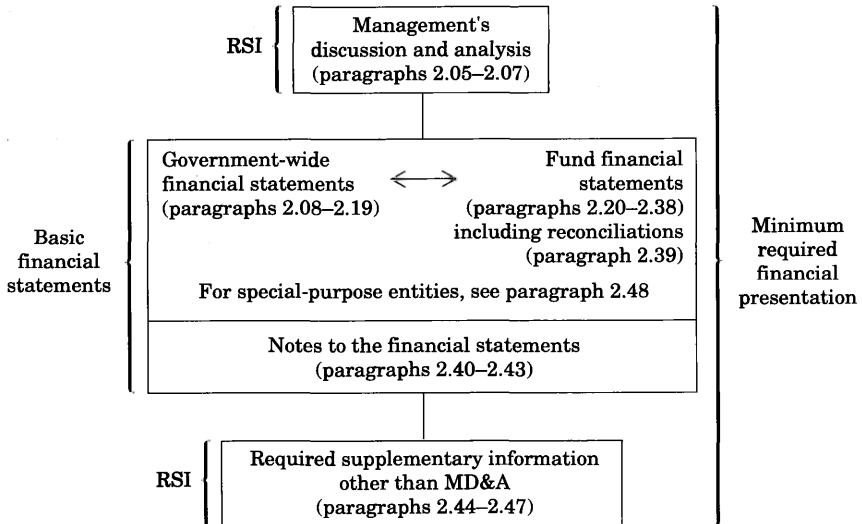
2.04 The principal GASB pronouncement establishing standards for the form and content of the basic financial statements to be issued by all state and local governmental entities is GASB Statement No. 34, as amended.² Additional guidance is provided in the GASB staff documents, *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A) and *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A).³ Various nonauthoritative illustrations of the financial statement presentation and note disclosure requirements of GASB Statement No. 34 are in appendixes of GASB Statements No. 34 and No. 35, the GASB 34 Q&A, and the 2nd GASB 34 Q&A. Various other NCGA and GASB pronouncements also address the form and content of governmental financial statements, including note disclosures. Various GASB pronouncements and GASB staff implementation guides address and illustrate the form and content of the RSI that accompanies the basic financial statements. This section of this chapter discusses the presentation of the basic financial statements and RSI; other chapters in this Guide provide more detail about certain aspects of those financial statements and RSI.

2.05 The minimum required financial presentation for governments is composed of three sections: (1) management's discussion and analysis (MD&A), which is RSI, (2) the basic financial statements, and (3) RSI other than MD&A. For many governments, the basic financial statements have three sections: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. Exhibit 2.1 includes a graphical representation of the minimum required financial presentation, with cross-references to related paragraphs in this chapter.

² Among the GASB standards that amend GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, is GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. Statement No. 35 amends Statement No. 34 to include public colleges and universities within its scope.

³ This Guide only considers the contents of the GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A) as it relates to that Q&A's items 1 through 6 on assessing materiality in preparing financial statements and certain other areas. Future AICPA staff conforming changes to this Guide will consider other guidance provided in that Q&A.

Exhibit 2.1

Minimum Required Financial Presentation**Management's Discussion and Analysis**

2.06 MD&A is RSI that introduces the basic financial statements by presenting certain financial information as well as management's analytical insights on that information. That analysis should provide users with the information they need to help them assess whether the government's financial position has improved or deteriorated as a result of the year's operations. Paragraphs 8 through 11 of GASB Statement No. 34, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, provide the standards for MD&A, which should precede the basic financial statements. The information to be presented in MD&A should be confined to the topics discussed in GASB Statement No. 34, paragraph 11, summarized as follows:

- a. A brief discussion of the basic financial statements, including the relationships of the statements to each other, and the significant differences in the information they provide
- b. Condensed financial information derived from the government-wide financial statements comparing the current year to the prior year, including certain specific elements listed in GASB Statement No. 34, paragraph 11b, if relevant
- c. An analysis of the government's overall financial position and results of operations to assist users in assessing whether financial position has improved or deteriorated as a result of the year's operations
- d. An analysis of balances and transactions of individual funds
- e. An analysis of significant variations between original and final budget amounts and between final budget amounts and actual budget results for the general fund (or its equivalent)

- f. A description of significant capital asset and long-term debt activity during the year
- g. Specific information by governments that use the modified approach to report some or all of their infrastructure assets
- h. A description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations

Currently known indicates information that management is aware of as of the date of the auditor's report. As clarified in the GASB 34 Q&A, item 13, the MD&A discussions should be based on events or decisions that already have occurred, or have been enacted, adopted, agreed upon, or contracted. Governments should not discuss the possible effect of potential future events or decisions. (See the examples of items that are and are not currently known facts, decisions, or conditions in the GASB 34 Q&A, item 13.) Further, because the information to be presented in MD&A should be confined to specific topics, governments should not present in MD&A any topics other than those discussed in GASB Statement No. 34, paragraph 11.

2.07 MD&A should focus on the primary government and distinguish between information pertaining to the primary government and its component units. Discussing matters relating to component units in MD&A is a matter of professional judgment, as discussed in Chapter 3, "The Financial Reporting Entity." (RSI other than MD&A is discussed in paragraphs 2.44 through 2.47.)

Government-Wide Financial Statements

2.08 The government-wide financial statements are highly aggregated financial statements that present financial information for all assets (including infrastructure capital assets), liabilities, and net assets of a primary government and its component units,⁴ except for fiduciary funds.⁵ The government-wide financial statements use the economic resources measurement focus and accrual basis of accounting. Those financial statements are designed to help users assess the finances of the government in its entirety, including the year's operating results; determine whether the government's overall financial position improved or deteriorated; and evaluate whether the government's current-year revenues were sufficient to pay for current-year services. They also are designed to help users assess the cost of providing services to its citizenry; determine how the government finances its programs—through user fees and other program revenues versus general tax revenues; understand the extent to which the government has invested in capital assets, including roads, bridges, and other infrastructure assets; and make better comparisons between governments.

2.09 Paragraphs 12 through 62 of GASB Statement No. 34, as amended, provide the standards for the government-wide financial statements. The government-wide financial statements are the statement of net assets and the statement of activities. The statements should:

⁴ Primary governments and component units are legally separate entities that are included together in a financial reporting entity's financial statements. See the discussion in Chapter 3, "The Financial Reporting Entity."

⁵ GASB Statement No. 34 provides that component units that are fiduciary in nature are displayed with fiduciary funds in the fiduciary fund financial statements. This Guide uses the term *fiduciary funds* to refer not only to a primary government's fiduciary funds but also to its component units that are fiduciary in nature. This Guide refers to component units that are not fiduciary in nature as blended component units or discretely presented component units.

- Include the primary government and its component units, except for fiduciary funds.
- Use separate rows and columns to distinguish between the total primary government (including its blended component units) and its discretely presented component units.
- Use separate rows and columns to distinguish between the primary government's governmental and business-type activities. Governmental activities generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues and usually are reported in governmental funds and internal service funds.⁶ Business-type activities are financed in whole or in part by fees charged to external parties for goods or services and usually are reported in enterprise funds.⁷ (See the discussion of fund classifications starting at paragraph 2.22.)
- Present total columns for the primary government. A total column for the entity as a whole may be presented but is not required. Prior-year data may be presented in the government-wide financial statements but also are not required. (See the further discussion of prior-period comparative financial information at paragraphs 2.50 and 2.51.)

2.10 The government-wide financial statements should use the economic resources measurement focus and accrual basis of accounting. They should recognize the effect of exchange and exchange-like transactions when the exchange takes place. They should recognize the effect of nonexchange transactions in accordance with the requirements of GASB Statements No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*.

2.11 GASB Statement No. 34, paragraph 17, states that recognition and reporting for governmental and business-type activities should be based on all applicable GASB pronouncements,⁸ as well as Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee

⁶ Internal service fund asset and liability balances that are not eliminated in the statement of net assets normally should be reported in the governmental activities column. (See Chapter 9, "Interfund, Internal, and Intra-entity Activity and Balances," concerning the eliminations of inter-fund activities and balances.) However, if enterprise funds are the predominant or only participants in an internal service fund, that internal service fund's residual assets and liabilities should be reported within the business-type activities column in the statement of net assets.

⁷ The GASB staff document, *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A), item 18, indicates that the statement of activities usually follows the categorizations used in the fund financial statements—governmental activities are those that usually are accounted for in governmental funds, and business-type activities are those that usually are accounted for in enterprise funds. However, governments can realign their activities if they believe that it more faithfully represents their operating objectives and philosophies. The reconciliations from the governmental and enterprise fund financial statements to the government-wide statements, as discussed in paragraph 2.39, would explain the reclassification.

⁸ If a GASB pronouncement specifies the application of a particular FASB pronouncement, governments should apply that FASB pronouncement even if it is superseded by a subsequent FASB pronouncement. For example, NCGA Interpretation 8, *Certain Pension Matters*, as amended and interpreted, requires governments to apply the provisions of FASB Statement No. 74, *Accounting for Special Termination Benefits Paid to Employees*. FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, superseded FASB Statement No. 74. However, the provision in FASB Statement No. 88 superseding FASB Statement No. 74 conflicts with the requirement in NCGA Interpretation 8 to apply FASB Statement No. 74.

on Accounting Procedure issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.⁹ GASB Statement No. 34 also states that business-type activities also may apply FASB pronouncements issued after November 30, 1989, as provided in paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended. Paragraph 7 of GASB Statement No. 20, as amended, provides that an enterprise fund also may apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements.¹⁰ The GASB 34 Q&A, item 20, clarifies that the election to apply post-November 30, 1989 FASB pronouncements to business-type activities is based on the election made for the underlying enterprise funds. GASB Statement No. 34 specifically addresses the applicability of FASB Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation*, as amended and interpreted, as discussed further in Chapters 8, “Expenses/Expenditures and Liabilities,” and 12, “Special-Purpose and State Governments.”

2.12 Footnote 13 to paragraph 17 of GASB Statement No. 34 provides that changes in accounting principles, addressed in APB Opinion No. 20, *Accounting Changes*, as amended, should be reported as restatements of beginning net assets and fund equity, not as a separately identified cumulative effect in the current-period statement of activities or proprietary fund statement of revenues, expenses, and changes in fund net assets. (That is, the cumulative effect should not be included in the change in net assets for the current year but, instead, should be reported as an adjustment of net assets at the beginning of the period.)

Statement of Net Assets

2.13 The statement of net assets should report all financial and capital resources, including infrastructure capital assets, except that certain capital assets need not be capitalized, such as certain collections of works of art. (Chapter 7, “Capital Assets,” discusses the accounting, financial reporting, and auditing considerations for capital assets.) The statement of net assets is the only financial statement that reports general capital assets and general long-term liabilities, which are capital assets and long-term liabilities that are not specifically related to activities reported in proprietary or fiduciary funds and that are associated with and generally arise from governmental activities.

2.14 Governments are encouraged to present the statement of net assets in a format that displays assets less liabilities equal net assets; however, they may use the traditional balance-sheet format (assets equal liabilities plus net assets). Regardless of the format used, the statement should label the difference between assets and liabilities as *net assets* and display it in three

⁹ Unless affected by subsequent GASB pronouncements, nonconflicting, noncontradictory private-sector pronouncements issued on or before November 30, 1989, remain effective for governmental financial statements even if those pronouncements are superseded, amended, or interpreted by subsequent FASB pronouncements. However, business-type activities that apply post-November 30, 1989 FASB pronouncements as discussed in the next sentence should apply superseding, amending, or interpreting FASB pronouncements except for those that conflict with or contradict GASB pronouncements.

¹⁰ Paragraph 33 in the nonauthoritative Basis for Conclusions of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, provides that AICPA pronouncements issued after November 30, 1989, and not made specifically applicable to governmental entities should be applied using the same logic used in the application of post-November 30, 1989 FASB standards.

components—(1) “invested in capital assets, net of related debt,” (2) “restricted” (distinguishing between major categories of restrictions), and (3) “unrestricted.” Chapter 10, “Equity and Financial Statement Reconciliations,” discusses the financial reporting and auditing considerations for equity (net assets, fund balances, and fund equity), and explains the differences between the equity amounts and components reported in the various financial statements.

2.15 GASB Statement No. 34 encourages governments to present assets and liabilities in the statement of net assets in order of their relative liquidity. An asset’s liquidity should be determined by how readily it is expected to be converted to cash and whether restrictions limit the government’s ability to use the resources.¹¹ A liability’s liquidity is based on its maturity, or when cash is expected to be used to liquidate it. The liquidity of an asset or liability may be determined by assessing the average liquidity of the class of assets or liabilities to which it belongs, even though individual balances may be significantly more or less liquid than others in the same class and some items may have both current and long-term elements. Liabilities whose average maturities are greater than one year should be reported in two components—the amount due within one year and the amount due in more than one year.¹² Alternatively, governments may present a classified statement of net assets, which distinguishes between all current and long-term assets and liabilities using the classification provisions for the proprietary funds statement of net assets or balance sheet as discussed in paragraph 2.33.

Statement of Activities

2.16 GASB Statement No. 34, as amended, requires the statement of activities to present activities accounted for in governmental funds at a minimum by function and activities accounted for in enterprise funds at a minimum by different identifiable activities. NCGA Statement 1 defines a function as a group of related activities that is aimed at accomplishing a major service or regulatory responsibility (such as public safety, public works, and education). GASB Statement No. 37 states that an activity within an enterprise fund is *identifiable* if it has a specific revenue stream and related expenses and gains and losses that are accounted for separately. Determining whether an activity is *different* generally is based on the goods, services, or programs provided by an entity, but may require the use of professional judgment. For example, providing natural gas differs from supplying water or electricity, although all three are utility services. Conversely, separate water districts are not “different” activities, although they may serve different areas. GASB Statement No. 34 and this Guide use the term *function* to refer to the level of detail presented in the statement of activities for both governmental and business-type activities. GASB Statement No. 34 encourages governments to provide data in the statement of activities at a more detailed level than by function if doing so provides more useful information without significantly reducing the statement’s understandability.

2.17 A government should present its statement of activities in a format that reports the net (expense) revenue (also known as *net cost*) of its individual functions. That format identifies the extent to which each function’s expenses

¹¹ The GASB 34 Q&A, item 82, discusses how the reporting of restricted assets under the “order of liquidity” approach is based on the time length of the restriction.

¹² The GASB 34 Q&A, item 83, discusses how governments should determine when compensated absences are “due.”

(except those that meet the definition of special or extraordinary items or transfers) are self-financing through program revenues—which are charges for services and restricted grants and contributions—or instead draw from the government’s general revenues. General revenues,¹³ contributions to term and permanent endowments, contributions to permanent fund principal, special and extraordinary items, and transfers should be reported separately after the total net expenses of the government’s functions, ultimately arriving at the “change in net assets” for the period. GASB Statement No. 34, paragraph 54, provides an example of a format that meets those requirements. (Certain special purpose governments may modify the standard format of the statement of activities or use an alternative format; see Chapter 12.)

2.18 Chapter 8 explains how expenses are classified into the various functions or as special or extraordinary items. Chapter 7 discusses the measurement and reporting of depreciation expense on capital assets. Chapter 6 explains how resource inflows are classified as program revenues, general revenues, contributions to term and permanent endowments, contributions to permanent fund principal, and special and extraordinary items.

Internal and Intra-Entity Activity and Balances

2.19 In aggregating data for the statement of net assets and the statement of activities, some amounts reported as interfund activity and balances in the fund financial statements should be eliminated or reclassified. Chapter 9, “Interfund, Internal, and Intra-Entity Activity and Balances,” explains those eliminations and reclassifications. That chapter also explains how activities and balances between the primary government and its component units should be reported.

Fund Financial Statements

2.20 The fund financial statements consist of a series of statements that focus on information about the government’s major governmental and enterprise funds as well as its internal service and fiduciary fund types. Those financial statements present additional and detailed information about the activities in the primary government’s governmental and proprietary funds, including its blended component units. In addition, those statements provide the only presentation in the basic financial statements for the activity and balances of fiduciary funds. The financial statements for the three fund categories—governmental, proprietary, and fiduciary—use different measurement focuses and bases of accounting to demonstrate fiscal accountability for governmental funds and operational accountability for proprietary and fiduciary funds.

2.21 Paragraphs 63 through 112 of GASB Statement No. 34, as amended, provide many of the standards for the fund financial statements. Separate financial statements should be presented for governmental funds, proprietary funds, and fiduciary funds. This section of this chapter describes fund classifications, fund aggregation, and the fund financial statements. Chapters 5 through 10 discuss the accounting, financial reporting, and auditing considerations in the fund financial statements for specific activities and balances, including interfund activity and balances, which are unique features of governmental financial statements.

¹³ General revenues are all revenues except those required to be reported as program revenues or as contributions or special or extraordinary items.

Fund Classifications

2.22 A government's accounting system usually is organized on a fund basis. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the government establishes for accountability purposes in accordance with statutes, laws, regulations, restrictions, or specific purposes. There is no specific number of funds that a government should use. NCGA Statement 1, paragraph 29, states that a government "should establish and maintain those funds required by law and sound financial administration" and that "only the minimum number of funds consistent with legal and operating requirements should be established." Further, NCGA Statement 1, paragraph 30, as amended, indicates that individual funds are not required for financial reporting purposes unless required by legal requirements or by GASB standards, which occasionally require that particular activities be accounted for in a specific fund type. For example, NCGA Statement 1, paragraph 30, as amended, requires the use of a debt service fund if financial resources are being accumulated for future-period debt principal and interest payments.

2.23 Governments should report governmental, proprietary, and fiduciary funds in the fund financial statements to the extent they have activities that meet the criteria in NCGA Statement 1, as amended, and GASB Statement No. 34, as amended, for using those funds. A summary of the resources and activities accounted for and reported in the eleven fund types, by category, follows:

a. Governmental funds

- (1) *General fund*—All financial resources except those required to be reported in another fund (A government should report only one general fund.)
- (2) *Special revenue funds*—The proceeds of specific revenue sources (other than for trusts for individuals, private organizations, or other governments or for major capital projects) that are legally restricted to expenditure for specified purposes
- (3) *Capital projects funds*—Financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds or in trust funds for individuals, private organizations, or other governments), including capital outlays financed by general obligation bonds
- (4) *Debt service funds*—The accumulation of resources for and the payment of general long-term debt principal and interest
- (5) *Permanent funds*—Resources that are legally restricted to the extent that only earnings and not principal may be used for purposes that support the reporting government's programs—that is, for the benefit of the government or its citizenry

b. Proprietary funds

- (6) *Enterprise funds*—Permitted or required for any activity for which a fee is charged to external users for goods or services (see paragraph 2.24)
- (7) *Internal service funds*—Permitted for any activity that provides goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost-reimbursement basis when the reporting government is the predominant participant in the activity

- c. Fiduciary funds (see also paragraph 2.25)
 - (8) *Pension (and other employee benefit) trust funds*—Resources that are required to be held in trust for the members and beneficiaries of defined benefit pension plans, defined contribution plans, other postemployment benefit (OPEB) plans, or other employee benefit plans
 - (9) *Investment trust funds*—The external portion of external investment pools that the government sponsors
 - (10) *Private-purpose trust funds*—All other trust arrangements under which principal and income benefit individuals, private organizations, or other governments
 - (11) *Agency funds*—Resources held in a purely custodial capacity for individuals, private organizations, or other governments

2.24 Enterprise funds may be used to report any activity for which a fee is charged to external users for goods or services. However, GASB Statement No. 34, paragraph 67, states that activities are required to be reported as enterprise funds if any one of the following criteria is met in the context of the activity's principal revenue sources, focusing on fees charged to external users.

- a. The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity. (Debt that is secured in part by a portion of its own proceeds should be considered as payable "solely" from the revenues of the activity.)
- b. Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.
- c. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs.

Footnote 33 in paragraph 67 of GASB Statement No. 34 states that these criteria do not require insignificant activities of governments to be reported as enterprise funds. Footnote 34 in paragraph 67 of GASB Statement No. 34 and GASB Statement No. 10, paragraph 18, require that state unemployment compensation funds and public entity risk pools, respectively, always be reported in enterprise funds. (See the further discussion of state unemployment compensation funds and public entity risk pools in Chapter 12.)

2.25 A government's fiduciary funds should report only those resources held in a trust or custodial capacity for individuals, private organizations, or other governments. Any resources held for the government itself should be reported in the entity's governmental or proprietary funds. Further, the trust funds generally are distinguished from agency funds by the existence of a trust agreement that affects the degree of management involvement and the length of time that the resources are held.

Fund Aggregation

2.26 A government's governmental and proprietary fund financial statements should present each of its major governmental and enterprise funds (as discussed in paragraph 2.27) in a separate column. Nonmajor governmental and nonmajor enterprise funds should be aggregated and displayed in single

columns. The proprietary fund financial statements should aggregate and display all internal service funds in a single column. The fiduciary fund financial statements should aggregate and display fiduciary funds by fund type.

2.27 A government's main operating fund (the general fund or its equivalent) always should be reported as a major fund. Other individual governmental and enterprise funds¹⁴ should be reported as major funds if their total assets, liabilities, revenues, or expenses/expenditures (excluding revenues and expenses/expenditures that are extraordinary items) are:

- a.* At least 10 percent of the corresponding total element (assets, liabilities, and so forth) for all funds of that category or type (that is, the total governmental fund category or the total enterprise fund type), and
- b.* The same element (assets, liabilities, and so forth) that met the 10 percent criterion in item *a* is at least 5 percent of the corresponding element total for all governmental and enterprise funds combined.

Further, any other governmental or enterprise fund may be reported as a major fund if the government's officials believe it is particularly important to financial statement users. The GASB 34 Q&A includes a nonauthoritative exercise on determining major funds.

Governmental Fund Financial Statements

2.28 Governmental fund financial reporting focuses primarily on the sources, uses, and balances of current financial resources. The financial statements required for governmental funds are the (a) balance sheet and (b) statement of revenues, expenditures, and changes in fund balances. Those financial statements should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. The governmental funds balance sheet does not report general capital assets or general long-term liabilities. Instead, the statement of revenues, expenditures, and changes in fund balances reports the financial resource inflows and outflows arising from the disposition and acquisition of general capital assets, the issuance and repayment of general long-term debt, and the maturation of nondebt general long-term liabilities, such as compensated absences and claims and judgments.¹⁵ Capital assets and long-term liabilities associated with and generally arising from activities reported in the governmental funds are reported only in the governmental activities column of the government-wide financial statements.

2.29 The governmental funds balance sheet should report information about the current financial resources (assets, liabilities, and fund balances) for each major governmental fund, nonmajor governmental funds in the aggregate, and in total for all governmental funds. This statement should use a balance-sheet format (assets equal liabilities plus fund balances); using a net asset format is not an alternative. Fund balances should be segregated into reserved and unreserved amounts (see Chapter 10).

¹⁴ The GASB 34 Q&A, item 181, explains that the major fund reporting requirements apply to blended component units, which are discussed in Chapter 3. Similarly, blended component units are included in the totals of governmental and enterprise funds used to determine major funds.

¹⁵ See the discussion in Chapter 8, "Expenses/Expenditures and Liabilities," of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. Matured nondebt general long-term liabilities are liabilities that normally are due and payable in full when incurred.

2.30 The governmental funds statement of revenues, expenditures, and changes in fund balances should report information about the inflows, outflows, and balances of current financial resources using the same columnar presentations as does the balance sheet using the following required format, as provided for in GASB Statement No. 34, paragraph 86:

Revenues (detailed)

Expenditures (detailed)

Excess (deficiency) of revenues over expenditures

Other financing sources and uses, including transfers (detailed)

Special and extraordinary items (detailed)

Net change in fund balances

Fund balances (both reserved and unreserved)—beginning of period

Fund balances—end of period

Proprietary Fund Financial Statements

2.31 Proprietary fund reporting focuses on the determination of operating income, changes in net assets (or cost recovery), financial position, and cash flows. The financial statements required for proprietary funds are the (a) statement of net assets or balance sheet, (b) statement of revenues, expenses, and changes in fund net assets or fund equity, and (c) statement of cash flows. Those financial statements should be presented using the economic resources measurement focus and the accrual basis of accounting.

2.32 GASB Statement No. 34, paragraph 93, states that proprietary funds should be reported based on all applicable GASB pronouncements as well as FASB Statements and Interpretations, APB Opinions, and ARBs of the Committee on Accounting Procedure issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. In addition, GASB Statement No. 34, paragraph 94, states that, for enterprise funds, governments may elect to apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements, based on the provisions of paragraph 7 of GASB Statement No. 20, as amended.¹⁶ GASB Statement No. 20, paragraph 8, encourages that the same application of FASB pronouncements be used for all enterprise funds in the basic financial statements. See the further discussion of the applicability of private-sector standards in paragraphs 2.11 and 2.12.

2.33 The proprietary funds statement of fund net assets or balance sheet should report information about the economic resources (assets, liabilities, and net assets) for each major enterprise fund, all nonmajor enterprise funds in the aggregate, and in total for all enterprise funds. It also should report the combined total for all internal service funds in a separate column to the right of the total enterprise funds column. This statement may use either a net assets format (assets less liabilities equal net assets) or a balance-sheet format (assets equal liabilities plus net assets). Net assets should be displayed in the three components as required for the government-wide statement of net assets (see paragraph 2.14). Assets and liabilities should be presented in a classified

¹⁶ The provision in GASB Statement No. 34, paragraph 94, to elect to apply all nonconflicting, noncontradictory post-November 30, 1989 FASB pronouncements applies only to enterprise funds, not also to internal service funds.

format, distinguishing between current and long-term assets and liabilities, as discussed in Chapter 3 of ARB 43, *Restatement and Revision of Accounting Research Bulletins*. Restricted assets should be reported when restrictions on asset use change the nature or normal understanding of the availability of the asset. Item 209 in the GASB 34 Q&A and item 10 in the 2nd GASB 34 Q&A discuss the reporting of restricted assets using a classified format.

2.34 The statement of revenues, expenses, and changes in fund net assets or fund equity should distinguish between operating and nonoperating revenues and expenses (as discussed in Chapter 6) and present a separate subtotal for operating revenues, operating expenses, and operating income. The statement should use the same columnar presentations as does the statement of fund net assets or balance sheet using the following required format, as provided for in GASB Statement No. 34, paragraph 101:

Operating revenues (detailed)

Total operating revenues

Operating expenses (detailed)

Total operating expenses

Operating income (loss)

Nonoperating revenues and expenses (detailed)

Income before other revenues, expenses, gains, losses, and transfers

Capital contributions, additions to permanent and term endowments,
special and extraordinary items (detailed), and transfers

Increase (decrease) in net assets

Net assets—beginning of period

Net assets—end of period

2.35 Governments should present a statement of cash flows for proprietary funds based on the provisions of GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, as amended, using the direct method of presenting cash flows from operating activities (including a reconciliation of operating cash flows to operating income). GASB Statement No. 9 requires that a statement of cash flows classify cash receipts and payments according to whether they stem from operating, noncapital financing, capital and related financing, or investing activities, and it provides definitions of each category. The Statement also requires the reporting of information about all investing, capital, and financing activities during a period that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period. The GASB 34 Q&A includes an nonauthoritative exercise that illustrates how governments can indirectly determine amounts of operating cash receipts and payments by adjusting for beginning and ending receivables and payables. The GASB staff document, *Guide to Implementation of GASB Statement No. 9 on Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting: Questions and Answers*, provides additional guidance.¹⁷

¹⁷ Note that the GASB staff document, *Guide to Implementation of GASB Statement No. 9 on Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting: Questions and Answers* was issued before GASB Statement No. 34 and, thus, includes some out-of-date guidance about the statement of cash flows.

Fiduciary Fund Financial Statements

2.36 The financial statements required for fiduciary funds are the (a) statement of fiduciary net assets and (b) statement of changes in fiduciary net assets. Those financial statements should be presented using the economic resources measurement focus and the accrual basis of accounting, except for the recognition of certain liabilities of defined benefit pension plans and certain postemployment healthcare plans. (Chapter 12 of this Guide discusses GASB standards for the recognition of those liabilities.) The statement of fiduciary net assets should use a net assets format (assets less liabilities equal net assets); using a balance-sheet format is not an alternative. The statements should provide a separate column for each fund type. The GASB 34 Q&A, item 223, clarifies that each fiduciary component unit should be reported within the appropriate fiduciary fund types, rather than aggregated in a separate fiduciary component units column.

2.37 The statement of fiduciary net assets should include information about the assets, liabilities, and net assets for each fiduciary fund type, but the components of net assets, discussed in paragraph 2.14, are not required to be presented in this statement. In the statement of fiduciary net assets, agency fund assets should equal liabilities. The statement of changes in fiduciary net assets should include information about the additions to, deductions from, and net increase (or decrease) for the year in net assets for each trust fund type, providing information about significant year-to-year changes in net assets. Agency funds should not be reported in the statement of changes in fiduciary net assets.

2.38 Detailed recognition and presentation requirements for defined benefit pension plans, certain postemployment health care plans, and investment trust funds are discussed in Chapter 12. GASB Statement No. 34, paragraphs 108 and 109, extends the detailed display requirements of GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*, to the financial statements for other employee benefit trust funds.

Financial Statement Reconciliations

2.39 Governments should present summary reconciliations to the government-wide financial statements at the bottom of the governmental and proprietary fund financial statements or in accompanying schedules. Those reconciliations will help financial statement users understand how the fund financial statements relate to the government-wide financial statements. See the further discussion of the financial reporting and auditing considerations for those financial statement reconciliations in Chapter 10.

Notes to the Financial Statements

2.40 The notes to the financial statements should communicate information essential for the fair presentation of the basic financial statements that is not displayed on the face of the financial statements. As such, the notes are an integral part of the basic financial statements. GASB standards require specific note disclosures for various types of activities and balances that are unique to or significant in government. Note disclosure is needed only when the information required to be disclosed is not displayed on the face of the financial statements.

2.41 The notes to the financial statements should focus on the primary government—specifically, its governmental activities, business-type activities, major funds, and nonmajor funds in the aggregate. Information about the government’s discretely presented component units may need to be presented in the notes, as discussed in Chapter 3.

2.42 The principal guidance for note disclosures is contained in NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, as amended. Various other NCGA and GASB pronouncements, such as GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, also establish note disclosure requirements. Many of the chapters in this Guide discuss note disclosures required for governmental financial statements. The following are among the significant required disclosures that are not discussed elsewhere in this Guide:

- A description of the government-wide financial statements, noting that fiduciary funds are not included
- The measurement focus and basis of accounting used in the government-wide statements
- The policy for applying FASB pronouncements issued after November 30, 1989, to business-type activities and to enterprise funds of the primary government
- For governments that present their primary government in more than a single column, a description of the activities accounted for in each major fund, the internal service funds, and the fiduciary fund types (For other than the general fund or its equivalent, the descriptions should be specific to the government, rather than general definitions that could describe any government.)
- Material violations of finance-related legal and contractual provisions and the actions taken to address such violations

2.43 The notes to the financial statements should include a summary of significant accounting policies, as required by NCGA Statement 1 and APB Opinion No. 22, *Disclosure of Accounting Policies*. As provided for in APB Opinion No. 22, paragraph 12, the summary of significant accounting policies should encompass those accounting principles and methods that involve any of the following:

- A selection from existing acceptable alternatives
- Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in the industry
- Unusual or innovative applications of GAAP (and, as applicable, of principles and methods peculiar to the industry in which the entity operates)

NCGA Interpretation 6, paragraph 6, as amended by GASB Statement No. 34, states that while a summary of significant accounting policies is a required disclosure, it may be a stand-alone summary or may be included as the initial note to the financial statements. If it is a stand-alone summary, each page of the basic financial statements should be referenced thereto and also to the notes to financial statements.

Required Supplementary Information Other Than MD&A

2.44 Several GASB pronouncements require the presentation of RSI. RSI differs from other types of information that accompanies the basic financial

statements because the GASB considers RSI an essential part of financial reporting and has established authoritative guidelines for measuring and presenting that information.

2.45 Governments should present budgetary comparison information for the general fund and for each major special revenue fund that has a legally adopted annual budget. GASB Statement No. 34 provides that budgetary comparison information should be presented as RSI, rather than as a basic financial statement, because that information is not considered essential to the users' understanding of the financial position and results of operations of a government. However, GASB Statement No. 34 also permits governments to elect to report the required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as RSI. The budgetary comparison information should present both (a) the original and (b) the final appropriated budgets for the reporting period as well as (c) actual inflows, outflows, and balances, stated on the government's budgetary basis. This information will demonstrate whether resources were obtained and used in accordance with the entity's legally adopted budget. See the further discussion of the financial reporting and auditing considerations for budgetary comparison information in Chapter 11, "The Budget."

2.46 The following GASB standards include provisions for RSI other than MD&A (discussed in paragraphs 2.06 and 2.07) and budgetary comparison information (discussed in paragraph 2.45):

- GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended by GASB Statement No. 30, *Risk Financing Omnibus*, requires public entity risk pools to include certain revenue and claims development information. (See Chapter 12.)
- GASB Statement No. 25 requires that certain defined benefit pension plans present a schedule of funding progress and a schedule of employer contributions. GASB Statement No. 26 does not require a schedule of funding progress and a schedule of employer contributions for postemployment healthcare plans. However, if those plans present those schedules as SI, GASB Statement No. 26 requires that they include all information that is required for pension plans. (See Chapter 12.)
- GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, requires the disclosure of certain multi-year actuarial data by employers that participate in single-employer and agent multiple-employer defined benefit pension plans. (See Chapter 8.)
- GASB Statement No. 34 requires schedules of assessed condition and estimated and actual maintenance and preservation costs for governments that use the modified approach for infrastructure assets. (See Chapter 7.)

The GASB requirements for certain RSI also provide for certain notes to the RSI. As discussed in Chapter 14, those notes are part of the prescribed guidelines. Further, presenting RSI for discretely presented component units is a matter of professional judgment, as discussed in Chapter 3.

2.47 GASB Statement No. 34, paragraph 6 and footnote 5, requires that RSI other than MD&A be presented immediately following the notes to the financial statements, except for the revenue and claims development information presented by certain public entity risk pools, as discussed in the public entity risk pools section of Chapter 12.

Special-Purpose Governments

2.48 *Special-purpose governments* are legally separate entities that perform only one activity or only a few activities, such as cemetery districts, school districts, colleges and universities, utilities, hospitals and other health care organizations, and public employee retirement systems. GASB Statement No. 34 provides that certain special-purpose governments should present different basic financial statements from those described above. The required financial statements for those entities are designed to be appropriate to the nature and mix of the activities they perform. See the further discussion of the financial reporting and auditing considerations for special-purpose governments in Chapter 12.

Other Financial Reporting Issues

Supplementary Information

2.49 Although SI is not required to accompany the basic financial statements, many governments present this information with their basic financial statements. GASB standards exist for certain SI, such as the combining and individual fund financial statements, that should be presented in a Comprehensive Annual Financial Report (CAFR). A CAFR comprises the basic financial statements and RSI accompanied by certain SI. NCGA Statement 1, paragraph 139, as amended, contains the requirements for the contents of a CAFR. The SI in a CAFR includes:

- a. *Introductory section*—This section includes a table of contents, letter(s) of transmittal, and other material deemed appropriate by management.
- b. *Combining statements and individual fund statements and schedules*—This section has the following:
 - Combining statements, which should be presented for (1) nonmajor funds by fund type of the primary government (including its blended component units),¹⁸ (2) the nonmajor discretely presented component units, and (3) the funds of individual component units if the information is not available in separately issued financial statements of the individual component units.
 - Individual fund statements, which should be presented when the primary government has only one nonmajor fund of a given fund type (unless presented in the combining statements) or if they are needed to present prior-year and budgetary comparisons that are not presented in RSI.
 - Schedules, which should be used to (1) demonstrate compliance with finance-related legal and contractual provisions, (2) present information spread throughout the statements that can be brought together and shown in greater detail, and (3) present greater detail for information reported in the statements.
- c. *Statistical section*—This section presents comparative data for several periods of time—often ten years or more—as well as data from sources other than the accounting records, such as assessed valuations and tax rates, economic and population data, and the legal debt margin.

¹⁸ The Comprehensive Annual Financial Report (CAFR) also should present a combining statement of changes in assets and liabilities for all agency funds.

Prior-Period Comparative Financial Information

2.50 Governments sometimes present partial or summarized (or partial and summarized) prior-period comparative financial information in their financial statements rather than making a complete prior-period presentation at the level of detail required by GAAP. For example, a government may present prior-year financial information only for its government-wide financial statements and not also for its fund financial statements. As another example, a government may present prior-year financial information in its government-wide financial statements only for the total reporting entity rather than disaggregated by governmental activities, business-type activities, total primary government, and discretely presented component units.

2.51 If prior-period financial information is presented in a partial or summarized manner and does not include the minimum information required by GAAP, the nature of the prior-period information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements. Such labeling and disclosure is supported by the provisions of Chapter 2A of ARB 43, paragraph 3, which states “it is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out.” (ARB 43 applies to the government-wide and proprietary fund financial statements and may be applied to the governmental and fiduciary fund financial statements as “other accounting literature.”) The use of appropriate titles includes a phrase such as “with [*partial / summarized*] financial information for the year ended June 30, 20PY,” as part of the title of the statement or, instead, column headings that indicate the partial or summarized nature of the information. Labeling the prior-period partial or summarized financial information “for comparative purposes only” without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title. An example of a note to the financial statements¹⁹ that describes the summarized nature of prior-period information would be as follows:

The basic financial statements include certain prior-year summarized comparative information in total but not at the level of detail required for a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the government’s financial statements for the year ended June 30, 20PY, from which the summarized information was derived.

Chapter 14, “Audit Reporting,” discusses auditors’ reports on prior-period financial information.

Auditing Considerations

2.52 A significant consideration in auditing a government’s financial statements is to understand the unique requirements for financial statement presentation. Auditors should understand the GASB’s standards for financial statement presentation as discussed in this and other chapters of this Guide, as well as the engagement’s reporting objective as discussed in Chapter 4. Chapter 14 discusses the effect on the auditor’s opinions in various situations when a government’s basic financial statements are not presented in conformity with GAAP.

¹⁹ Because the note discusses information that does not pertain to the current-period financial statements, the note is not considered to be part of the current-period financial statements.

Compliance Requirements

2.53 As discussed in Chapter 4, the auditor should determine that a government's financial statements appropriately consider compliance requirements that have a direct and material effect on the determination of financial statement amounts. For example, the auditor should consider evaluating whether separate funds are maintained and reported when required by legal or contractual provisions, such as those arising from the entity's own constitutional or legislative provisions and from grants, contributions, and appropriations received from other governments and from nongovernmental entities. Legal and contractual provisions may sometimes use the terminology *separate funds* or *separate accounts*, when the intention of those provisions is a separate accounting for restricted resources, which does not necessarily require the government to establish separate funds or bank accounts for the resources. An example of a situation that may require evaluation of whether a separate accounting is intended is a debt agreement (covenant or indenture) that specifies that the entity maintain separate depreciation, bond reserve, and debt service "funds." Conversely, legal and contractual provisions may require a segregation of resources for a particular purpose but not use the terminology *separate funds*. The auditor may need to consult legal counsel to evaluate whether legal or contractual provisions require the use of separate funds for financial reporting purposes.

Fund and Activity Classifications

2.54 One consideration in the audit of a government's financial statements is whether the government has properly segregated activities into funds and reported its funds in the proper fund classifications. Those classifications depend not only on compliance requirements, as discussed in paragraph 2.53, but also on the GAAP definitions of the various funds, as discussed in paragraphs 2.22 through 2.25. Another consideration is whether a government's activities are properly classified as governmental or business-type in the government-wide financial statements. Those classifications depend on the GAAP definitions relating to those classifications as well as the government's fund classification of the underlying fund activity, as discussed in paragraph 2.09 and footnotes 6 and 7.

Major Funds

2.55 The auditor should evaluate the government's quantitative determination of major funds to determine whether all required major funds are separately displayed in the fund financial statements. Chapter 14 discusses the effect on the auditor's report if quantitatively determined major funds are not separately displayed. GASB Statement No. 34 permits (but does not require) governments to report as a major fund any governmental or enterprise fund other than those that meet the quantitative criteria if the government's officials believe it is particularly important to financial statement users. That permitted presentation of major funds based on management judgment gives management broad discretion in designating additional funds as major, and the auditor is not required to evaluate management's judgment in that regard. However, the auditor should consider obtaining a written representation from current management indicating that management believes that all judgmentally determined major funds are particularly important to financial statement users. The standards for selecting major funds could result in different funds

being reported as major each year. As discussed in Chapter 14, such changes should not be considered a change in accounting principles affecting consistency.²⁰ Chapter 10 discusses how auditors should consider performing procedures on the opening equity of major funds that they did not audit as major the previous year.

Restricted Assets

2.56 Assets are reported in the financial statements as restricted when the nature and amount of those assets satisfy the applicable legal and contractual provisions. The auditor should consider evaluating the adequacy of the government's compliance with restrictions and its financial reporting of those restrictions, and consider the effect on the auditor's report on the financial statements. For example, the auditor may find that assets restricted for debt retirement include amounts due from other funds. In that situation, there is an implication that the underlying assets have not been appropriately restricted from general use and, thus, noncompliance with the requirement for restriction of the assets.

Notes to the Financial Statements

2.57 As stated earlier in this chapter, the notes to the financial statements should communicate information essential for fair presentation of the basic financial statements that is not displayed on the face of the financial statements. In addition to that basic rule, certain notes to the financial statements are specifically required for the basic financial statements to be in conformity with GAAP. Chapter 4 discusses the auditor's responsibility concerning whether the government makes required disclosures in conformity with GAAP. The auditor should consider evaluating whether the government's basic financial statements properly present all material note disclosures and the effect on the auditor's report on the financial statements if material disclosures are omitted or not presented in conformity with GAAP, as further discussed in Chapter 13, "Concluding the Audit."

2.58 Like the provisions of all GASB standards, notes to the financial statements are not required for immaterial items. In fact, NCGA Interpretation 6, paragraph 6, states that "The notes to financial statements should not be cluttered with unnecessary and immaterial disclosures. Attendant circumstances and materiality must be considered in assessing the propriety of the notes to the financial statements disclosures." The auditor should consider evaluating whether the government's notes to the financial statements present unnecessary and immaterial disclosures and, if so, consider advising the government if any such disclosures have been made. However, the presentation of unnecessary and immaterial disclosures does not affect the auditor's report on the financial statements because the presentation does not cause material misstatements of the financial statements.

Required Supplementary Information and Supplementary Information

2.59 Chapter 4 discusses the procedures that an auditor applies to RSI and SI, and Chapter 14 discusses auditor reporting on RSI and SI. As noted

²⁰ Management may, in the interest of interperiod consistency, choose to report a governmental or enterprise fund as a major fund even though it does not meet the quantitative criteria.

earlier in this chapter, GASB standards require MD&A to precede the basic financial statements and most other RSI to be presented immediately following the notes to the financial statements. Although SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558.10), discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB-required supplementary information given the GASB's specific requirements for placement. If a government does not place GASB-required supplementary information in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines. (As discussed in Chapter 14, the manner in which RSI is presented does not affect the auditor's *opinions* on the opinion units presented in the basic financial statements.)

2.60 Only information required by the GASB and the FASB can be considered RSI. As part of the limited procedures on RSI, the auditor should consider whether MD&A and other RSI includes information that is not required by the GASB or the FASB.²¹ For example, information presented in MD&A should be confined to the topics discussed in GASB Statement No. 34, paragraph 11, as amended (as discussed in paragraph 2.06). If the government presents nonrequired information as part of RSI, the auditor should consider whether to report that the RSI content constitutes a presentation that departs materially from prescribed guidelines.

Other Financial Reporting Considerations

2.61 Chapter 14 discusses the presentation of summary financial information (popular reports). Chapter 15, "Comprehensive Bases of Accounting Other Than Generally Accepted Accounting Principles," discusses the presentation of financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP. Financial statements presented on this basis are referred to as OCBOA financial statements.

Accounting and Financial Reporting Alternatives

2.62 GASB standards permit various accounting and financial reporting alternatives. Although GASB standards do not identify any alternatives as preferable, they do state or imply that the use of certain alternatives are encouraged.²² Chapter 14 discusses the auditor's evaluation of a change in accounting principles relating to accounting and financial reporting alternatives that are identified as preferable and encouraged. Appendix A to this chapter, "Accounting and Financial Reporting Alternatives in GASB Statement No. 34, as Amended," lists certain accounting and financial reporting alternatives contained in GASB standards and identifies those alternatives that are encouraged. The auditor should consult GASB and applicable private-sector standards for the status of other alternatives. General disclosure standards regarding accounting and financial reporting alternatives are noted in paragraph 2.43.

²¹ At present, there is no FASB-required supplementary information that affects governmental entities. Any future FASB-required supplementary information should be presented only by those funds and activities that choose to apply post-November 30, 1989 FASB pronouncements as discussed in paragraphs 2.11 and 2.32.

²² Certain private-sector standards applicable to governmental entities do identify preferable accounting and financial reporting alternatives as well as encouraged alternatives.

Transition to GASB Statement No. 34

Training and Resource Materials

2.63 The auditor should consider obtaining appropriate training and resource materials relating to the new financial reporting model required by GASB Statement No. 34. There are various training opportunities and resource materials available to preparers and auditors to assist with understanding the requirements for financial statement presentation, including a GASB Statement No. 34 resource page on the GASB Web site at <http://www.gasb.org>.

Effective Date

2.64 The overall effective date requirements for the new financial reporting model are in GASB Statement No. 34, paragraphs 142 through 144, and GASB Statement No. 35, paragraphs 6 through 8, and discussed in the following paragraph. Chapter 7 discusses additional effective date standards relating to general infrastructure assets. Chapter 3 discusses the coordination of the effective date of GASB Statement No. 34 between primary governments and their component units.

2.65 GASB Statement No. 34 is effective in three phases for the following dates, as noted in Table 2.1, for all governments except in certain situations for component units, as discussed in paragraph 2.66. The phases are based on the total annual revenues of the primary government's governmental and enterprise funds, total annual additions of special-purpose governments engaged only in fiduciary activities, or total annual revenues of a public college or university. Earlier application is encouraged.

Table 2.1

GASB Statement No. 34 Effective Dates

Phase	Total Annual Revenues in the First Fiscal Year Ending After June 15, 1999	Implementation Required for First Period Beginning After June 15
1	\$100 million or more	2001
2	\$10 million to \$100 million	2002
3	Less than \$10 million	2003

For purposes of determining a government's implementation phase, *revenues* does not include the revenues of discretely presented component units. It also does not include extraordinary items, other financing sources, or (for public colleges and universities) additions to investment in plant.

2.66 A component unit is required to implement GASB Statement No. 34 no later than the same year as its primary government, even if that is earlier than the component unit's established implementation phase and even if its primary government implements the standard early. Component units are permitted to implement GASB Statement No. 34 earlier than their primary governments. In addition, component units may be required to implement GASB Statement No. 34 earlier than their primary governments based on the phases discussed in paragraph 2.65. (See also the sections on transition to GASB Statement No. 34 in Chapters 3 and 14.)

2.67 Some governments did not prepare their financial statements in conformity with GAAP in the first fiscal year ending after June 15, 1999. For example, some governments presented their financial statements using a cash or modified cash basis of accounting that represents an OCBOA. Other governments did not include all of the funds, organizations, institutions, agencies, departments, and offices that are part of the primary government and blended component units as defined in GASB Statement No. 14, *The Financial Reporting Entity*. Therefore, those governments do not have the GAAP-based measure of total annual revenues that is needed to determine their appropriate implementation phase for GASB Statement No. 34.

2.68 The presumption of the effective date provisions of GASB Statement No. 34 is that the revenue amounts are measured in conformity with GAAP. That presumption is supported by the GASB 34 Q&A, item 264, which states that, in determining the implementation phase, governmental fund revenues are based on actual modified accrual amounts. Even governments that intend to continue the presentation of cash or modified cash OCBOA financial statements have to determine their implementation phase under GASB Statement No. 34. As explained in Chapter 15, a government that issues OCBOA financial statements using the cash or modified cash basis of accounting generally should present the basic financial statements and communicate the display elements required by GAAP. Such format and disclosure requirements include those arising from GASB Statement No. 34 when that Statement becomes effective for the government.

2.69 Governments that did not prepare GAAP-basis financial statements in the first fiscal year ending after June 15, 1999, will have to determine (for example, through estimation procedures) the GAAP-basis revenues for their governmental and enterprise funds for that period. The auditor should consider evaluating whether the annual revenues used to determine the government's implementation phase include the revenues of all governmental and enterprise funds of the primary government's legal entity and of its blended component units. Auditors should perform procedures on revenue amounts to determine whether they are in conformity with GAAP. However, auditors should note that, in the absence of unusual events, such as nonrecurring revenues or significant changes in cash collection patterns, a government's cash- or modified cash-basis revenues may not differ significantly from GAAP-basis revenues. The amounts may not differ significantly because all measures of annual revenues usually contain twelve months of activity. Further, a government may not have to demonstrate precision in determining GAAP-basis annual revenue if its revenues are significantly above or below the threshold for a particular implementation phase. For example, if a primary government had \$50 million in annual cash-basis revenues in its governmental and enterprise funds in the first fiscal period after June 15, 1999, highly unusual events would have had to occur to move that entity out of the \$10 million to \$100 million implementation phase (phase 2). However, if those events meet the definition of extraordinary items, they should not be considered in measuring revenues for purposes of determining the implementation phase.

Transition Requirements

2.70 GASB Statement No. 34 requires adjustments to governmental, proprietary, and fiduciary funds resulting from a change to comply with the Statement to be treated as adjustments of prior periods. Financial statements

presented for the periods affected should be restated. However, if restatement is not practical, the cumulative effect of applying the Statement should be reported as a restatement of beginning fund balance or fund net assets, as appropriate, for the earliest period restated. In the first period the Statement is applied, the financial statements should disclose the nature of the restatement and its effect. Chapter 10 discusses audit considerations relating to how a government identifies the beginning net assets it will present in the government-wide statement of activities in the first period GASB Statement No. 34 is applied.

2.71 GASB Statement No. 34 permits governments to apply two private-sector standards and one GASB proprietary activity standard to governmental activities in the government-wide financial statements on a prospective basis only. Those standards are:

- APB Opinions No. 12, *Omnibus Opinion—1967*, and No. 21, *Interest on Receivables and Payables*, as amended, which require deferral and amortization of debt issue premium or discount (However, those Opinions should be applied retroactively to deep-discount or zero-coupon debt. Deep-discount debt is debt that is sold at a discount of 20 percent or more from its face or par value at the time it is issued. Zero-coupon debt is originally sold at far below par value and pays no interest until it matures.)
- GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, which requires deferral and amortization of the difference between the reacquisition price and the net carrying amount of old debt in debt-refunding transactions

Management's Discussion and Analysis

2.72 GASB Statement No. 34 does not require governments to restate prior periods for purposes of providing the comparative data for MD&A in the first period the Statement is applied. However, in that period, governments are encouraged to provide comparative analyses of key elements of total governmental funds and total enterprise funds in MD&A. In addition, governments are required to state that, in future years, when prior-year information is available, a comparative analysis of government-wide data will be presented. GASB Statement No. 35 contains similar provisions for public colleges and universities.

Fund Classifications

2.73 GASB Statement No. 34 redefines enterprise, internal service, and agency funds; eliminates the expendable and nonexpendable trust funds; creates the permanent funds and private-purpose trust funds; and expands the pension trust funds into the pension and other employee benefit trust funds. Because of those changes, governments will have to consider whether they have properly segregated activities into funds and reported their funds in the proper fund classifications. The auditor should consider evaluating management's decisions about fund classifications under GASB Statement No. 34.

A.1 GASB Statement No. 34, as amended, includes numerous accounting and financial reporting alternatives, which are provisions that permit an unconditional choice between two or more approaches. In many situations, that Statement encourages the use of one alternative over another. Table 2.A.1 lists those alternatives and identifies those that are encouraged with a checkmark.

Table 2.A.1

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
MD&A	<ul style="list-style-type: none"> Using charts, graphs, and tables is encouraged to enhance the understandability of the MD&A. 	✓	paragraph 9
Government-wide financial statements (GWFS)	<ul style="list-style-type: none"> A total column for the reporting entity as a whole may or may not be presented. Prior-year data may or may not be presented. 		<p>paragraph 14</p> <p>paragraph 14</p>
GWFS—statement of net assets	<p>Presentations</p> <ul style="list-style-type: none"> Presenting the statement using a net assets format, rather than a balance sheet format, is encouraged. Presenting assets and liabilities in order of their relative liquidity, rather than classifying them as between current and long-term, is encouraged. <p>Capital assets</p> <ul style="list-style-type: none"> Accumulated depreciation may be reported on the face of the statement of net assets or disclosed in the notes. Capital assets may be reported in detail, such as by major class of asset—for example, infrastructure, buildings and improvements, vehicles, machinery and equipment (although disclosure of the details is required). 	<p>✓</p> <p>✓</p>	<p>paragraph 30</p> <p>paragraph 31 and footnote 23</p> <p>paragraph 20</p> <p>paragraph 20</p>

(continued)

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
GWFS—statement of activities	Level of detail		
	<ul style="list-style-type: none"> Presenting data at a more detailed level than by function (for governmental activities) or different identifiable activities (for business-type activities) is encouraged if that presentation provides more useful information without reducing understandability. 	√	paragraph 40
	<ul style="list-style-type: none"> Presenting a statement of activities as supplementary information other than required supplementary information (known as SI) is encouraged for (a) governments that want to present disaggregated data for their multiple-function enterprise funds beyond what is required for segment reporting and (b) special-purpose governments engaged only in business-type activities 	√	paragraph 123
	Indirect expenses		
	<ul style="list-style-type: none"> None, some, or all indirect expenses may be allocated among functions. 		paragraph 42
	<ul style="list-style-type: none"> If indirect expenses are allocated, a column totaling direct and indirect expenses may or may not be presented. 		paragraph 42
	<ul style="list-style-type: none"> Administrative overhead charges for “centralized” expenses may be eliminated or not. Disclosure is required if those charges are not eliminated. 		paragraph 43
	Depreciation expense		
	<ul style="list-style-type: none"> Depreciation expense on noninfrastructure capital assets that serve essentially all functions may be (a) allocated ratably as a direct expense among functions, (b) reported as a separate line item, or (c) reported in an “indirect” function (such as “general government”). A disclosure is required on the face of the statement if a separate line item is used. 		paragraph 44

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
	<ul style="list-style-type: none"> • Depreciation expense on general infrastructure assets may be reported as a direct expense of the function associated with capital outlay or as a separate line item. 		paragraph 45
Fund classification	<ul style="list-style-type: none"> • An enterprise fund may or may not be used to report any activity for which a fee is charged to external users for goods or services. (There are three situations in which the use of an enterprise fund is required.) • An internal service fund may or may not be used to report any activity that provides goods or services to other funds, departments, or agencies of the primary government or its component units, or to other governments. However, to use an internal service fund, the reporting government has to be the predominant participant in the activity. 		paragraph 67 paragraph 68
Major funds	<ul style="list-style-type: none"> • Any governmental or enterprise fund that the government's officials believe is particularly important to financial statement users may be presented as a major fund. (There is a two-step test for determining which governmental and enterprise funds are required to be reported as major funds.) 		paragraph 76
Proprietary fund financial statements	<ul style="list-style-type: none"> • The financial position statement may be presented using either a net assets format or a balance sheet format. • In the financial position statement, the difference between assets and liabilities may be labeled either <i>fund net assets</i> or <i>fund equity</i>. (Regardless of the label used, however, the net assets or equity should be displayed in the three components, as discussed in GASB Statement No. 34, paragraph 98.) 		paragraph 91, footnote 39, and paragraph 98 paragraph 91, footnote 40

(continued)

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
	<ul style="list-style-type: none"> Revenues may be reported either (a) net of discounts and allowances with the discount or allowance amount presented parenthetically in the financial statement or in a note to the financial statements or (b) gross with the related discounts and allowances reported directly below the revenue amount 		paragraph 100, footnote 41
Fiduciary fund financial statements	<ul style="list-style-type: none"> The components of net assets—invested in capital assets, net of related debt; restricted; and unrestricted—may or may not be presented in the statement of fiduciary net assets. (Other GASB Statements require specific equity presentations for certain fiduciary funds.) 		paragraph 108
Infrastructure assets	<ul style="list-style-type: none"> Networks or subsystems of networks of infrastructure assets may be reported by using the modified approach or by reporting depreciation expense. (Two requirements for using the modified approach have to be met.) For infrastructure assets reported using the modified approach, condition assessments may be performed using statistical samples or on a cyclical basis. Governments that do not use the modified approach but gather the information required to be presented as required supplementary information (RSI) were they to use that approach are encouraged to provide that information as SI. Phase 1 and 2 governments (those with total annual revenues of \$10 million or more in the first fiscal year ending after June 15, 1999) may limit retroactive reporting of general infrastructure assets to major general infrastructure assets acquired, renovated, 	✓	<p>paragraph 23</p> <p>paragraph 23, footnote 19</p> <p>paragraph 133, footnote 58</p> <p>paragraphs 148, 154, and 156</p>

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
	restored, or improved in fiscal years ending after June 30, 1980. ¹		
	<ul style="list-style-type: none"> • Phase 3 governments (those with total annual revenues of less than \$10 million in the first fiscal year ending after June 15, 1999) are not required to retroactively report general infrastructure assets.² 		paragraph 148
	<ul style="list-style-type: none"> • Governments in all phases may retroactively report all general infrastructure assets. 	✓	paragraphs 148 and 156
	<ul style="list-style-type: none"> • If the actual historical cost of existing major general infrastructure assets is not practically determinable, historical cost may be estimated using any approach that complies with the intent of GASB Statement No. 34. 		paragraph 155
Works of art, historical treasures, and similar assets	<ul style="list-style-type: none"> • Capitalization is encouraged, but not required, for collections that are not capitalized at June 30, 1999, and that are (a) held for public exhibition, education, or research in furtherance of public service, rather than financial gain; (b) protected, kept unencumbered, cared for, and preserved; and (c) subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections. 	✓	paragraph 27 and footnote 22
Depreciation	<ul style="list-style-type: none"> • Any established depreciation method may be used, including composite methods. • Depreciation may be based on the estimated useful life of a class of assets, a network of assets, a subsystem of a network, or individual assets. 		paragraphs 22, 161, 163, and 164 paragraphs 22 and 161

(continued)

¹ Similar guidance concerning the retroactive reporting of general infrastructure assets is provided in GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, paragraph 10.

² See footnote 1.

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
	<ul style="list-style-type: none"> For estimated useful lives, governments can use (1) general guidelines obtained from professional or industry organizations, (2) information for comparable assets of other governments, or (3) internal information. 		paragraph 161
Private-sector standards and previous GASB proprietary activity standards	<ul style="list-style-type: none"> Business-type activities and enterprise funds may use all post-November 30, 1989 FASB pronouncements unless they conflict with or contradict GASB pronouncements, or they may use none of them. (According to item 20 of the GASB 34 Q&A, the election to apply post-November 30, 1989 FASB pronouncements to business-type activities is based on the election made for the underlying enterprise funds.) Using the same application of FASB pronouncements for all enterprise funds is encouraged. FASB Statement No. 71, <i>Accounting for the Effects of Certain Types of Regulation</i>, and related pronouncements issued on or before November 30, 1989, may or may not be applied to qualifying enterprise funds. The following standards may be applied prospectively only to governmental activities in the government-wide financial statements: (a) APB Opinions No. 12, <i>Omnibus Opinion—1967</i>, and No. 21, <i>Interest on Receivables and Payables</i>, concerning the deferral and amortization of debt issue premiums and discounts, except for deep-discount or zero-coupon debt and (b) GASB Statement No. 23, <i>Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities</i>. 	√	<p>paragraphs 17 and 94</p> <p>paragraph 94</p> <p>paragraph 95</p> <p>paragraph 146, as amended</p>

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
Budgetary information	<ul style="list-style-type: none"> Budgetary comparison information should be presented as RSI, unless the government elects to report it as a basic financial statement. (RSI is the encouraged presentation.) 	√	paragraph 130, footnote 53
	<ul style="list-style-type: none"> Reporting the variance between the final budget and actual amounts is encouraged but not required. 	√	paragraph 130
	<ul style="list-style-type: none"> The variance between original and final budget amounts may or may not be presented. 		paragraph 130
	<ul style="list-style-type: none"> Budgetary comparison schedules may be presented using (a) the same format, terminology, and classifications as in the budget document or (b) the format, terminology, and classifications in a statement of revenues, expenditures, and changes in fund balances. 		paragraph 131
	<ul style="list-style-type: none"> If the budgetary comparison schedules are presented as RSI, required information that reconciles budgetary information to GAAP information may be presented either in a separate RSI schedule or in notes to RSI. 		paragraph 131
Component unit financial information	<ul style="list-style-type: none"> Information required by paragraph 51 of GASB Statement No. 14 about each major component unit can be provided by (a) presenting each major component unit in a separate column in the GWFS, (b) including combining statements of major component units in the basic statements after the fund financial statements, or (c) presenting condensed financial statements in the notes to the financial statements. Alternatives a and b include nonmajor component units aggregated in a single column. 		paragraph 126

(continued)

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
Single-program governments	<ul style="list-style-type: none"> • Special-purpose governments engaged in a single governmental program may combine their GWFS and fund financial statements using a columnar format that reconciles individual line items of fund financial data to government-wide data in a separate column on the face of the financial statements. Descriptions of reconciling items should be presented either on the face of the financial statements, in an accompanying schedule, or in the notes to the financial statements. • If special-purpose governments engaged in a single governmental program present separate GWFS and fund financial statements, they may present their government-wide statement of activities using a different format (such as a single column format). 		<p>paragraph 136 and footnote 6</p> <p>paragraph 136</p>
"Not-for-profit" governments	<ul style="list-style-type: none"> • Governments that reported as of June 30, 1999, using the AICPA Not-for-Profit model as defined in GASB Statement No. 29, <i>The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities</i>, but that do not meet the GASB 34 criteria for the use of an enterprise fund, may nevertheless use enterprise fund accounting and financial reporting. 		paragraph 147
Public employee retirement system (PERS) reporting	<ul style="list-style-type: none"> • PERS that administer more than one defined benefit pension plan or postemployment healthcare plan may (a) present a separate column for each plan on its financial statements or (b) present combining statements for those plans as part of its basic financial statements. 		paragraph 140

<i>Topic</i>	<i>Description of Alternative Methods and Presentations</i>	<i>Encouraged</i>	<i>References in GASB Statement No. 34</i>
	<ul style="list-style-type: none"> For all plans other than defined benefit pension plans or postemployment healthcare plans, a PERS is encouraged to present combining financial statements. 	√	paragraph 141
	Transition Requirements³		
Effective date	<ul style="list-style-type: none"> Application of GASB Statement No. 34 provisions earlier than the required effective dates is encouraged. 	√	paragraphs 142 and 148
MD&A ⁴	<ul style="list-style-type: none"> In the first period GASB Statement No. 34 is applied, prior period government-wide data may or may not be presented. (If not presented, a statement should be made that comparative government-wide data will be presented in the future.) 		paragraph 145
	<ul style="list-style-type: none"> If in the first period GASB Statement No. 34 is applied, comparative government-wide data is not presented, comparative analyses of key elements of total governmental and total enterprise funds is encouraged. 	√	paragraph 145

³ Some transition requirements are listed earlier in this appendix because they will have ongoing effect on a government's financial statements.

⁴ Similar guidance concerning management's discussion and analysis (MD&A) transition is provided in GASB Statement No. 35, paragraph 11.

Chapter 3

The Financial Reporting Entity

Introduction

3.01 Many governmental financial statements include the financial data of more than a single legal entity. Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, as amended, contains the standards for defining the governmental financial reporting entity and for identifying which legally separate entities are component units that should be included with another government (usually a primary government) in a financial reporting entity's financial statements. Requirements for including component units are based primarily on the concept of financial accountability, where elected officials are accountable to citizens for their public policy decisions, regardless of whether those decisions are carried out directly by the elected officials through the operations of the primary government or by their designees through the operations of specially created organizations.

3.02 GASB Statement No. 14, as amended, also contains standards for displaying component units in a financial reporting entity's basic financial statements. The Statement contains a concept of discrete presentation that separates the financial information of most component units from the financial information of the primary government. However, the financial information of some component units is blended with the financial information of the primary government.

3.03 The purpose of this chapter is to discuss the major elements of the financial reporting entity definition and related reporting matters to consider in planning, performing, evaluating the results of, and reporting on the audit. Refer to GASB Statement No. 14, as amended, for a complete discussion of the standards. Appendixes in GASB Statement No. 14 provide illustrative, nonauthoritative examples, disclosures, and financial statement presentations for the financial reporting entity. Additional guidance is provided in GASB staff documents, *Guide to Implementation of GASB Statement No. 14 on the Financial Reporting Entity: Questions and Answers*¹ (GASB 14 Q&A); *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A); and *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A).

GASB's Financial Reporting Entity Standards

3.04 The requirements of GASB Statement No. 14, as amended, apply to all state and local governments and to the financial reporting of the following:

¹ Note that the GASB staff document, *Guide to Implementation of GASB Statement No. 14 on the Financial Reporting Entity: Questions and Answers*, was issued before GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and, thus, includes some out-of-date guidance about the financial reporting of component units.

- Primary governments
- The separately issued financial statements of a governmental component unit
- Governmental joint ventures
- Jointly governed organizations
- Other stand-alone governments²

In addition, GASB Statement No. 14, as amended, should be applied to all governmental and nongovernmental component units when they are included in a governmental financial reporting entity.

Definition of the Financial Reporting Entity

3.05 The governmental financial reporting entity consists of the following:

- The primary government
- Organizations for which the primary government is financially accountable
- Other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the financial reporting entity's financial statements to be misleading or incomplete³

The nucleus of a financial reporting entity usually is a primary government. However, a government other than a primary government (such as a component unit, a joint venture, a jointly governed organization, or another stand-alone government) serves as the nucleus for its own financial reporting entity when it issues separate financial statements.

3.06 GASB Statement No. 14, paragraph 13, defines a primary government as any state government or general-purpose local government (for example, a municipality or county). A primary government also is a special-purpose government (for example, a school district or a park district) that meets all of the following criteria:

- It has a separately elected governing body.
- It is legally separate (see GASB Statement No. 14, paragraph 15).
- It is fiscally independent of other state and local governments (see paragraph 3.07).

The primary government consists of all funds, organizations, institutions, agencies, departments, and offices that make up the legal entity. GASB Statement No. 14, paragraph 19, as amended, states that the primary government also consists of funds for which it has a fiduciary responsibility, even though those funds may represent organizations that do not meet the definition for inclusion in the financial reporting entity.

² Other stand-alone governments are legally separate governments that (a) do not have a separately elected governing body and (b) do not meet the definition of a component unit. Other stand-alone governments include some special-purpose governments, joint ventures, jointly governed organizations, and pools.

³ GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, amends GASB Statement No. 14, *The Financial Reporting Entity*, to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. See the further discussion in footnote 4.

3.07 A special-purpose government is fiscally independent if it has the authority to do all three of the following:

- Determine its budget without another government's having the authority to approve and modify that budget.
- Levy taxes or set rates or charges without approval by another government.
- Issue bonded debt without approval by another government.

3.08 Component units include legally separate organizations (whether governmental, not-for-profit, or for-profit organizations) for which elected officials of the primary government are financially accountable. GASB Statement No. 14, paragraph 21, states the following about a primary government's financial accountability for a legally separate organization:

- A primary government is financially accountable if it appoints a voting majority of the organization's governing body and (a) it is able to impose its will on that organization or (b) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government. (See the discussion in paragraph 3.09.)
- The primary government may be financially accountable if an organization is fiscally dependent on the primary government regardless of whether the organization has (a) a separately elected governing board, (b) a governing board appointed by a higher level of government, or (c) a jointly appointed board. (An organization that is not fiscally independent is fiscally dependent on the primary government that holds one or more of the powers listed in paragraph 3.07.) See GASB Statement No. 14, paragraphs 34–38.

3.09 GASB Statement No. 14, paragraph 26, states that a primary government has the ability to impose its will on an organization if it can significantly influence the programs, projects, activities, or level of services performed or provided by the organization. It provides a list of conditions that indicate that ability. Further, Statement No. 14, paragraph 27, states that an organization can provide a financial benefit to, or impose a financial burden on, a primary government in a variety of ways and indicates that an organization has a financial benefit or burden relationship with a primary government if any one of the following conditions exist:

- The primary government is legally entitled to or can otherwise access the organization's resources.
- The primary government is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization.
- The primary government is obligated in some manner for the debt of the organization.

GASB Statement No. 14, as amended, provides a detailed discussion of those three manifestations of a financial benefit or burden relationship.

3.10 GASB Statement No. 14, as amended, also requires certain organizations to be included as component units if the nature and significance of their relationship with the primary governments are such that excluding them would render the financial reporting entity's financial statements misleading or incomplete. In general, this standard involves what are known as "affiliated organizations" (for example, a not-for-profit organization whose purpose is to

benefit a governmental university by soliciting contributions and managing those funds), although GASB Statement No. 14, paragraph 40, also refers to certain authorities that are created to provide temporary fiscal assistance to a local government. Determining whether the nature and significance of a potential component unit's relationship with the primary government warrants its inclusion in the financial reporting entity is a matter of professional judgment.⁴

3.11 GASB Statement No. 14, Appendix C, provides a nonauthoritative flowchart as an aid for evaluating potential component units of a particular financial reporting entity.

Financial Statement Presentation

3.12 GASB Statement No. 14, as amended, requires financial statement presentation that permits financial statement users to distinguish between the primary government and its component units.⁵ Some component units have close relationships with the primary government, and their financial statements should be blended as if they were part of the primary government. (See paragraphs 3.13 and 3.14.) However, the financial data for most component units should be discretely presented. (See paragraph 3.15.)

3.13 GASB Statement No. 14, as amended, explains that with blending, a component unit's balances and transactions are reported in a manner similar to the balances and transactions of the primary government itself. That is, for accounting and financial reporting purposes, blended component units generally should be treated the same as the funds of the primary government. For example, the funds of a blended component unit should be included in the appropriate fund financial statements (and combining and individual fund financial statements, if presented as supplementary information other than required supplementary information—known as SI⁶) of the primary government, and presented as major governmental or enterprise funds if they meet the major funds criteria.⁷ However, the general fund of a blended component unit should be reported as a special revenue fund. The financial data of blended component units also should be included with the primary government's financial data in the government-wide financial statements.

⁴ GASB Statement No. 39 amends GASB Statement No. 14 to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Generally, GASB Statement No. 39 requires reporting, as a discretely presented component unit, an organization that raises and holds economic resources for the direct benefit of a governmental entity. Such organizations are legally separate, tax-exempt entities that meet all of three specific criteria that address benefit, entitlement or access, and significance. GASB Statement No. 39 continues the requirement in GASB Statement No. 14 to apply professional judgment in determining whether the relationship between a primary government and other organizations for which the primary government is not financially accountable and that do not meet these criteria is such that exclusion of the organization would render the financial statements of the reporting entity misleading or incomplete. The provisions of GASB Statement No. 39 are effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged.

⁵ GASB Statement No. 34 provides that component units that are fiduciary in nature should be reported in the primary government's fund financial statements only (in the statements of fiduciary net assets and changes in fiduciary net assets), where that data is included with the appropriate fiduciary fund type. Those component units are treated the same as fiduciary funds and are therefore referred to in this Guide as fiduciary funds. This Guide refers to component units that are not fiduciary in nature as blended component units or discretely presented component units.

⁶ The auditor's responsibility for and reporting on supplementary information other than required supplementary information (known as SI) are discussed in Chapters 4, "Planning the Audit," and 14, "Audit Reporting," respectively.

⁷ Chapter 2, "Financial Reporting" discusses the major funds criteria.

3.14 GASB Statement No. 14, as amended, requires the use of the blending method for a component unit if the component unit's governing body is substantively the same as the governing body of the primary government. Blending also is required if the component unit directly or indirectly provides services entirely, or almost entirely, to the primary government or otherwise exclusively, or almost exclusively, benefits the primary government even though it does not provide services directly to it.

3.15 Component units are included in the financial reporting entity by discrete presentation if they do not meet the criteria for blending. Discrete presentation generally entails reporting component unit financial data in rows and columns separate from the financial data of the primary government. All discretely presented component units should be combined in one or more columns in the government-wide financial statements only (that is, they are not also displayed in the fund financial statements). That discrete column(s) should be located to the right of the total column of the primary government, distinguishing between the financial data of the primary government (including its blended component units) and those of the discretely presented component units by providing descriptive column headings. All presentations of the financial data of discretely presented component units in the reporting entity's government-wide financial statements should be made using the economic resources measurement focus and accrual basis of accounting.

3.16 GASB Statement No. 34, paragraph 61, provides that resource flows between a primary government and its blended component units should be reported using the Statement's standards for interfund and internal activity (see Chapter 9, "Interfund, Internal, and Intra-Entity Activity.") In the government-wide financial statements, resource flows between a primary government and its discretely presented component units, except those that affect the balance sheet only such as loans and repayments, should be reported as revenues and expenses. However, amounts payable and receivable between a primary government and its discretely presented component units or between those components should be reported on a separate line.

3.17 Chapter 12, "Special-Purpose and State Governments," in the section on financing authorities, discusses the standards for reporting lease arrangements between a primary government and its component units. National Council on Government Accounting (NCGA) Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, paragraphs 22 through 26, as amended, is the source of this guidance on reporting such lease arrangements.

3.18 A primary government and its component units may have the same or different fiscal year-ends. If there are different fiscal year-ends, the financial reporting entity reports using the primary government's fiscal year and incorporates financial statements for the component units' fiscal years ending during the reporting entity's fiscal year. If a component unit's fiscal year ends within the first quarter of the reporting entity's subsequent fiscal year, the component unit's financial statements for that subsequent year may be used if doing so does not adversely affect the timely and accurate presentation of the reporting entity's financial statements. (Chapter 9 discusses the effect on interfund, internal, and intra-entity activity and balances when a component unit's fiscal year differs from that of its primary government.)

3.19 GASB Statement No. 14, as amended, requires the financial reporting entity's basic financial statements to include information about each major discretely presented component unit. In determining which component units

are *major*, consideration should be given to each component unit's significance relative to the other component units and the nature and significance of its relationship to the primary government. The GASB 14 Q&A, item 90, states that "no specific benchmarks for evaluating 'significance' are established in GASB Statement No. 14 because they necessarily would be arbitrary." However, the item provides examples of both qualitative and quantitative characteristics to consider. (Note that the definition of *major* for this purpose is not solely quantitative, as it is for the definition of certain major governmental and enterprise funds.) The alternatives for presenting the required information about each major discretely presented component unit are as follows:

- Presenting each major component unit in a separate column in the government-wide statements (Nonmajor component units would be aggregated in a single column.)
- Including combining statements of major component units, with non-major units aggregated in a single column⁸ as a basic financial statement after the fund financial statements
- Presenting condensed financial statements in the notes to the basic financial statements (Certain minimum requirements for this disclosure are provided.)

3.20 GASB Statement No. 14, paragraph 51, as amended, requires that the data presented for each component unit in the combining statements generally be its aggregated totals, derived from the component units' statements of net assets and activities. Those aggregated totals should include amounts for the component units' own component units. (Because component units that are engaged only in business-type activities and that do not have discretely presented component units that are engaged in governmental activities⁹ are not required to prepare a statement of activities, that disclosure should be taken from the information provided in the component unit's statement of revenues, expenses, and changes in net assets.) Presentation of the fund financial statements of the individual component units is not required unless such information is not available in separately issued financial reports of the component unit. If separately issued financial information for a component unit is not available, fund financial statements for that component unit should be presented as SI.

Note Disclosures

3.21 GASB Statement No. 14, paragraphs 62 and 63, as amended, require the notes to the financial statements to distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units. Notes essential to fair presentation in the financial reporting entity's basic financial statements include those for individual discretely presented component units considering both (a) the unit's significance relative to the total discretely presented component units and (b) the nature and significance of the unit's relationship to the

⁸ GASB Statement No. 34, footnote 50, does not require a combining statement for the nonmajor component units as a basic financial statement. However, it states that such a combining statement may be presented as SI.

⁹ Item 260 of the GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers (GASB 34 Q&A)* indicates that a special-purpose government engaged only in business-type activities that has discretely presented component units that are engaged in governmental activities should present government-wide statements.

primary government. Determining which discretely presented component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit-by-component unit basis.

3.22 The notes to the financial reporting entity's financial statements also should include the following disclosures concerning component units as required by GASB Statements No. 14 and No. 34:

- A brief description of the component units of the financial reporting entity and their relationships to the primary government, including a discussion of the criteria for including the component units in the financial reporting entity and how the component units are reported
- Information about how the separate financial statements for the individual component units may be obtained
- If transactions between component units that have different fiscal years result in inconsistencies in amounts reported between the primary government and its component units, the nature and amount of those transactions
- Changes in fiscal years of component units
- The nature and amount of significant transactions that each major component unit has with the primary government and other component units

3.23 GASB Statement No. 14 also requires a primary government to disclose in the notes to the financial statements the nature of its accountability for related organizations. Related organizations include those for which the primary government is accountable because it appoints a voting majority of the board, but for which that same primary government is not financially accountable. Groups of related organizations with similar relationships with the primary government may be summarized for purposes of that disclosure. In addition, the primary government should disclose related-party transactions with its related organizations. The financial statements of a related governmental organization should disclose the primary government that is accountable for it and describe its relationship with that primary government. (Chapters 4, "Planning the Audit," and 13, "Concluding the Audit" discuss the reporting of and audit considerations for related-party transactions.)

Other Financial Reporting Requirements

3.24 GASB Statement No. 14, paragraph 62, states that required supplementary information (RSI) should distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units. Further, GASB Statement No. 34, paragraph 10, provides that, while the management's discussion and analysis (MD&A) should focus on the primary government, the MD&A should, when appropriate, include information pertaining to component units. That paragraph states: "Determining whether to discuss matters related to a component unit is a matter of professional judgment and should be based on the individual component unit's significance to the total of all discretely presented component units and that component unit's relationship with the primary government. When appropriate, the financial reporting entity's MD&A should refer readers to the component unit's separately issued financial statements." (Chapters 4 and 14, "Audit Reporting," discuss the limited procedures and auditor's reporting for RSI.)

3.25 GASB Statement No. 14, paragraph 64, states that if financial statements are issued that present only the data of the primary government,

they should acknowledge that they do not include the data of the component units necessary for reporting in conformity with generally accepted accounting principles. (Chapter 14 discusses the effect of that situation on the auditor's report.)

3.26 GASB Statement No. 14, paragraph 65, states that a component unit may serve as a nucleus for a financial reporting entity when it issues separate financial statements and should apply the provisions of GASB Statement No. 14, as amended. However, those separate financial statements should acknowledge that the government is a component unit of another government—for example, “Sample County School District, a component unit of Sample County.” In addition, the notes to the financial statements should identify the primary government in whose financial reporting entity the component unit is included and describe its relationship with the primary government.¹⁰

3.27 GASB Statement No. 14, as amended, also discusses the financial statement presentation and disclosure requirements pertaining to a financial reporting entity's relationships with the following types of organizations:

- Joint ventures
- Jointly governed organizations
- Component units and related organizations with joint venture characteristics
- Pools
- Undivided interests
- Cost-sharing arrangements

Auditing Considerations

3.28 The audit objectives relating to the definition, financial statement presentation, and disclosure of the financial reporting entity are as follows:¹¹

- The component units reported in the financial statements meet the criteria for inclusion in the financial reporting entity.
- All funds of the primary government and all component units are included in the financial reporting entity.
- If a component unit's fiscal year differs from that of the primary government, component unit information for the proper fiscal year is included in the financial reporting entity's financial statements.
- The component units' assets, liabilities, and equities presented in the financial reporting entity financial statements are consistent in amount and classification with their presentation in the separately issued component unit financial statements, if applicable, and consistent with the classification of similar items in the reporting entity's financial statements.¹²

¹⁰ As discussed in Chapter 14, the auditor's report on the component unit's separate financial statements also should disclose information that the entity is a component unit of a financial reporting entity.

¹¹ Similar audit objectives also relate to audits of the separately issued financial statements of governmental component units, joint ventures, jointly governed organizations, and other stand-alone governments.

¹² The presentation of component unit financial information in the reporting entity's financial statements need not be identical to its presentation in the component unit's financial statements, but any reclassification of component unit financial information should not distort the presentation of the component unit's financial information.

- Financial statement presentation and disclosures for component units and related organizations are in conformity with generally accepted accounting principles (GAAP) consistently applied.

3.29 The auditor should obtain an understanding of a government's internal control over the definition, financial statement presentation, and disclosures relating to the financial reporting entity. Those internal control features may include the following:

- Annual consideration and supervisory review that all of the primary government's funds are included in its financial statements
- Annual consideration and supervisory review of the potential component units and related organizations for reporting in the financial reporting entity's financial statements (including issues of inclusion, identification of major component units, method of presentation, and disclosure), including the need for changes in the presentation of component units since the prior-year financial statements because of changes in legal and contractual provisions that affect the operation of potential component units
- Procedures to communicate financial reporting requirements and results between the primary government and each of its component units and their separate auditors, if applicable (Primary governments sometimes obtain the information they need for financial reporting from their component units by having the component units complete a "reporting package" that provides the required information.)
- Procedures to appropriately incorporate component unit financial data into the financial reporting entity financial statements, including the notes thereto, and to appropriately disclose related entities

3.30 Audit procedures relating to the financial reporting entity may include—

- Asking management about the existence of potential component units, including whether the entity might have component units like those reported by similar governments
- Reviewing and evaluating that all of the government's funds are included in the primary government's financial statements
- Reviewing and evaluating the government's analysis of potential component units and related organizations for reporting in the financial reporting entity financial statements (including issues of inclusion, identification of major component units, method of presentation, and disclosure)
- Examining governing board minutes, amounts paid to other entities, local newspaper articles, the entity's internet Web site, the blue pages of telephone directories, statutes and ordinances, and other similar documents for evidence of funds, potential component units, and other related organizations that have not been reported in the financial reporting entity's financial statements as required by GAAP
- Consulting with legal counsel, officials with oversight of local government audits, and other appropriate monitoring or oversight officials (such as the state attorney general, state auditor, or auditor general), as needed, to determine whether potential component units are legally separate entities
- Examining the entity's incorporation of component unit financial data into the financial reporting entity financial statements, including the notes thereto, as well as its inclusion of primary government funds and its disclosure of related entities

3.31 During the planning stages of an audit, the auditor should assess whether the entity has properly identified its component units. This is important to ensure, for example, that:

- Major funds (the calculation of which is affected by blended component units) and opinion units are appropriately identified. (See the discussion of opinion units in Chapter 4.)
- The audit is properly coordinated. Some component units may be audited by other auditors. (See paragraph 3.35 and Chapter 4.) Delivery deadlines need to be established so that component unit audits are completed in time for those financial statements to be included in the financial reporting entity's financial statements. Some component units may not be audited. If that is the case, the component unit or primary government could arrange for a timely audit, or the auditor should discuss with the primary government the potential effect on the auditor's report on the reporting entity's basic financial statements of having an unaudited component unit.
- That appropriate audit personnel or consultants are available for those component units that require expertise on issues such as health care, insurance, and actuarial matters.

Presentation of Less Than All the Funds of the Primary Government

3.32 Some governments issue financial statements that present less than all the funds of the primary government. For example, they issue financial statements for the primary government, one or more individual funds, or a department, agency, or program. Further, some governments issue financial statements that omit one or more funds. Chapter 14 discusses the effects of those situations on the auditor's report.

Departures of Component Unit Information from GAAP

3.33 In some situations, component unit information in a financial reporting entity's financial statements might not be in conformity with GAAP. Consider these examples:

- A component unit is omitted or an included organization does not meet the provisions of GASB Statement No. 14, as amended, for inclusion as a component unit.
- The component unit's auditor has modified his or her opinion on the unit's separately issued financial statements because of a departure from GAAP or reported that the unit's financial statements are presented on an comprehensive basis of accounting other than GAAP (OCBOA financial statements).
- Information about a major component unit as required by GASB Statement No. 14, paragraph 51, as amended, is not included.
- The component unit is presented using the wrong inclusion method (that is, using discrete presentation instead of blending or vice versa).
- Note disclosures for a discretely presented component unit as required by GASB Statement No. 14, paragraphs 62 and 63, as amended, are omitted or incomplete.

When such a GAAP departure exists, the auditor should exercise professional judgment to determine whether the effect of that departure is material to the

financial statements of the opinion unit in which the component unit is reported. If the GAAP departure is considered material, the auditor should appropriately modify the opinion. See the discussion in Chapter 14 about the effect of GAAP departures in a component unit's financial information on the auditor's report.

3.34 It is possible that the financial information of a discretely presented component unit will be presented in the reporting entity financial statements using private-sector accounting and financial reporting standards because the component unit is not a governmental entity. Although there is no specific GASB requirement to do so, the reporting entity could disclose the component unit's use of nongovernmental standards following the note disclosure requirements of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles* and Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*, as well as GASB Statement No. 14, as amended.

Separate Component Unit Auditor

3.35 A component unit's auditor often is not the same as the primary government's auditor (the principal auditor). In those circumstances, it is important that the auditors establish an appropriate professional relationship. The principal auditor assumes certain responsibilities under Statement on Auditing Standards (SAS) No. 1, AU section 543, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of the Audit Performed by Other Independent Auditors"), as further discussed in Chapter 4. The component unit auditor may have to facilitate the principal auditor's performance of those responsibilities by, for example:

- Providing a representation of independence,
- Communicating with the principal auditor his or her awareness that the component unit's financial statements are to be included in the reporting entity's financial statements, and
- Permitting the principal auditor to review audit documentation.

In addition, the component unit auditor may be expected to participate in presenting financial statements of the component unit on a basis of accounting or fiscal year not typically used by the component unit for its separate reporting. It is important that the various auditors and their auditees agree early on matters that will affect the reporting entity's audited financial statements. Those matters might include, for example, the timing of the reports, the accounting and financial reporting principles to be applied (or other accounting and financial reporting information that the primary government needs for the reporting entity financial statements¹³), and the auditing standards to be applied (for example, whether the component unit's financial statements will be audited using *Government Auditing Standards*).¹⁴

¹³ For example, GASB Statement No. 34 does not require the financial statements of special-purpose governments engaged only in business-type activities to distinguish program revenues from general revenues. Some primary governments may require their component units engaged only in business-type activities to include information about program and general revenues in their basic financial statements so that audited information is available for the reporting entity's financial statements. Other governments will infer that information from the component unit financial statements as discussed in item 50 of the GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A).

¹⁴ Chapter 10 of SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (Appendix D of this Guide), discusses the necessary modifications to the auditor's reports on the reporting entity when a component unit does not have an audit in accordance with *Government Auditing Standards*.

Changes in the Financial Reporting Entity

3.36 As discussed in Chapter 2, “Financial Reporting,” certain private-sector pronouncements should or may be applied in governmental financial statements. One such pronouncement that should be applied is Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, as amended (and as affected by GASB Statement No. 34, footnote 13). APB Opinion No. 20, as amended, provides financial reporting requirements, including disclosure requirements, when there is a change in the financial reporting entity, such as one resulting from a change in the component units included in the financial reporting entity. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 420.07–.09, “Consistency of Application of Generally Accepted Accounting Principles”), provides that a change in the reporting entity that results from the creation, cessation, or complete or partial disposition of a subsidiary or other business unit does not require the auditor’s report to include an explanatory paragraph about consistency.

Other Component Unit Auditing Considerations

3.37 Chapter 14 discusses the following additional considerations concerning the principal auditor’s report on the financial reporting entity’s financial statements: (a) a component unit’s adoption of an accounting principle earlier than its adoption by the primary government, (b) the inclusion of an unaudited component unit in the financial reporting entity’s financial statements, and (c) the effect of another auditor’s work on RSI and SI.

Transition to GASB Statement No. 34

3.38 GASB Statement No. 34 establishes implementation dates for individual governments, including component units, based on their total annual revenues (or some similar measure) in the first fiscal year ending after June 15, 1999. However, that Statement also requires that a component unit implement the standards no later than the same year as its primary government, even if that is earlier than the component unit’s established implementation phase and even if its primary government implements the standard early. That Statement does not prohibit a component unit from choosing to implement the standards before the period in which its primary government implements them. (See the additional discussion of the effective date provisions of GASB Statement No. 34 in the transition sections of Chapters 2 and 7, “Capital Assets.”)

3.39 It is likely that different implementation phases for GASB Statement No. 34 will apply to many primary governments and their component units. In addition, many entities, including component units, may wish to adopt the Statement early. Consequently, there should be sufficient communication between the parties about implementation timing and other issues. If a component unit does not implement GASB Statement No. 34 when it is required to do so, the auditor should consider the effect of that departure from GAAP on the report on the component unit’s financial statements. Opinion modifications may be required even if the component unit’s failure to conform with GAAP results from the primary government’s early implementation of GASB Statement No. 34, or even if the component unit’s fiscal year ends earlier than does the primary government’s fiscal year. Opinion modifications on a component unit’s financial statements also may result in opinion modifications on the reporting entity financial statements. See the further discussion of this situation in the transition section of Chapter 14.

3.40 Sometimes a component unit prepares its financial statements in conformity with GAAP, but its primary government does not. However, a component unit has to know its primary government's GASB Statement No. 34 implementation phase to appropriately determine its own implementation phase, as discussed in paragraph 3.38. In those situations, component units will have to coordinate with their primary governments to determine the appropriate implementation phase. The transition section of Chapter 2 discusses the process of determining the implementation phase of a government that did not prepare its financial statements in conformity with GAAP in the first fiscal year ending after June 15, 1999.

Chapter 4

Planning the Audit

Introduction

4.01 This chapter addresses procedures for planning the audit of the financial statements of a governmental entity under generally accepted auditing standards (GAAS), including procedures that address the auditor's responsibilities for considering internal control over financial reporting and compliance requirements as they affect the financial statement audit. AICPA Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, discusses planning procedures for audits that also are conducted in accordance with the provisions of (a) *Government Auditing Standards*, as amended (also referred to as the Yellow Book), issued by the Comptroller General of the United States¹ and (b) the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. (See appendix D of this Guide.)

4.02 The Governmental Accounting Standards Board (GASB) establishes accounting and financial reporting standards for state and local governments. Chapter 2, "Financial Reporting," discusses governmental financial statements and certain auditing considerations relating to them. Chapter 3, "The Financial Reporting Entity," and Chapters 5, "Cash, Investments, and Investment-Related Activity," through 10, "Equity and Financial Statement Reconciliations," discuss the audit objectives, internal control features, and audit procedures that may be considered in developing audit programs for financial statement components and elements. The auditor plans his or her audit using auditing standards and interpretive publications, including this Guide, to meet the objectives of each specific audit engagement. As discussed in Statement on Auditing Standards (SAS) No. 31, *Evidential Matter*, as amended by SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements*, and SAS No. 80, *Amendment to Statement on Auditing Standards No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), most of the auditor's work in forming his or her opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions of management implicit in those financial statements. The audit objectives in this Guide have been listed using the five broad categories of financial statement assertions established in SAS No. 31, as amended: (1) existence or occurrence, (2) completeness, (3) rights and obligations, (4) valuation or allocation, and (5) presentation and disclosures.

4.03 SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), provides general guidance on the considerations and

¹ *Government Auditing Standards* requirements and guidance relating to financial audits are discussed in AICPA Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (Appendix D of this Guide), and its additional standards and guidance are outlined in paragraphs 3.8 and 3.9 and Tables 3.1 and 3.2 of the SOP. Those additional standards apply only when required by law, regulation, agreement, contract, or policy, including in an audit under the provisions of the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

procedures applicable to planning and supervising all audits. Planning the audit is required by GAAS, and the planning process continues throughout the audit. Early planning is useful in establishing the probable level and type of effort needed to conduct the engagement and is essential for an efficient and effective audit. In planning an audit of a government, the auditor should consider the following matters as discussed in this chapter:

- Communicating with the auditee
- Engagement reporting objectives
- Principal auditor status and independence
- The internal audit function
- Materiality
- Understanding the government
- Understanding governmental accounting and financial reporting standards
- Related parties and transactions
- Planning analytical procedures
- Internal control over financial reporting
- Financial statement misstatements
- Financial statement compliance requirements
- Required supplementary information and supplementary information
- Audit approach and program
- Other matters, such as communicating with the audit committee, client indemnification, and access to audit documentation

Planning Considerations

Communicating with the Auditee²

4.04 Communicating with the auditee is an ongoing process, beginning during audit planning and continuing through the delivery of the reports and, possibly, even after report delivery. During planning, the auditor should establish an understanding with the auditee as well as communicate engagement details. Those communications may need to be revised or supplemented as the audit progresses.

4.05 SAS No. 83, *Establishing an Understanding With the Client*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), states that the auditor should establish an understanding with the auditee regarding the services to be performed. Such understanding reduces the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. Preferably, the auditor should establish this understanding through written communication with the

² *Government Auditing Standards* includes an additional fieldwork requirement for communicating certain information to the auditee, the individuals contracting for or requesting audit services, and the audit committee during the planning stages of an audit. Those standards also include an additional general requirement for the audit organization to have an appropriate internal quality control system and an external quality control review every three years. A copy of the most recent external quality control review report should be provided to certain parties, including the auditee. See SOP 98-3 (Appendix D of this Guide).

auditee, and should maintain a record of the understanding in the audit documentation. If the auditor believes an understanding with the auditee has not been established, he or she should decline to accept the engagement. SAS Nos. 83 and 89 list matters that generally are included when the auditor establishes an understanding with the auditee regarding an audit of the financial statements. An engagement letter or contract is useful in establishing the necessary understanding between the auditee and the auditor, and such a letter or contract is recommended. Among other matters, the engagement letter or contract should include the type of engagement and whether it is intended to meet specific audit requirements (see paragraph 4.08). The auditor also may want to include, in the engagement letter or contract, requirements for access to audit documentation (see paragraph 4.62) and for reporting on internal control (see paragraph 4.60).

4.06 The auditor should consider holding a preaudit conference with the auditee to discuss the responsibilities of both the auditee and the auditor. The understandings reached during the preaudit conference should be documented as provided for in SAS No. 83, as amended. Topics for the preaudit conference with elements that are unique to or significant in a governmental audit could include:³

- Identification of audit staff that have knowledge and experience with governmental accounting, financial reporting, and audits⁴
- The use of other auditors and the effect of those other auditors on the timing of the audit and on the auditor's report (See paragraphs 4.09 through 4.15.)
- The effect of the use of service organizations (see paragraph 4.37) and specialists on audit procedures.
- Audit timing, including dates for the following:
 - Availability of records, especially when a government's accounting records are decentralized among several departments or other accountability centers
 - The required delivery of the report, which may be affected by legal and contractual provisions
- New accounting and financial reporting standards that the entity has or is required to implement (see paragraph 4.33)
- Reports to be provided by the auditor pursuant to the terms of the engagement (see paragraph 4.07)
- Applicable audit requirements, including the auditor's responsibility under SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), for communicating with management if the auditor becomes aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement (see paragraph 4.08)
- The effect of new auditing requirements on audit procedures or the scope of the audit
- The auditor's responsibilities for:

³ Discussion at the preaudit conference may be influenced by materiality determinations for financial statement preparation and audit purposes as discussed in paragraphs 4.18 through 4.30.

⁴ *Government Auditing Standards* includes an additional general requirement for continuing professional education for audit personnel in subjects directly related to the government environment and to government auditing or to the specific or unique environment in which the auditee operates. See SOP 98-3 (Appendix D of this Guide).

- Discovering and reporting material misstatements resulting from illegal acts, errors, or fraud (see paragraphs 4.39 through 4.48)
- Communicating certain matters to the audit committee or other party responsible for oversight of the financial reporting process, including information about uncorrected misstatements aggregated by the auditor that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements for the opinion units in the government's financial statements (see the discussion of materiality determinations and opinion units in a governmental audit in paragraphs 4.18 through 4.30 and the discussions about communications with the audit committee in paragraph 4.60 and Chapter 13, "Concluding the Audit")
- The auditee's responsibilities for:
 - Preparing worksheets, schedules, and other "prepared by client" (PBC) material needed for the audit
 - Preparing the basic financial statements, required supplementary information (RSI), including management's discussion and analysis (MD&A), and supplementary information other than required supplementary information, known as SI
 - Identifying all component units that should be reported in the reporting entity's financial statements and determining how they should be displayed
 - Identifying compliance requirements that have a direct and material effect on the determination of financial statement amounts and for disclosing applicable instances of noncompliance (See paragraphs 4.40 and 4.43 through 4.48.)
 - Adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements for the opinion units in the government's financial statements (See the discussion of materiality determinations and opinion units in a governmental audit in paragraphs 4.18 through 4.30.)
 - Identifying related-party transactions and for determining the appropriate reporting (See paragraph 4.34.)
 - Complying with any industry association certificate program requirements (if applicable) for the comprehensive annual financial report (CAFR)
 - Signing a management representation letter that may include government-specific representations (See Chapter 13.)
- The need for lawyer letters or for alternative procedures if the government does not retain inside or outside counsel and has not consulted a lawyer during the period about litigation, claims, or assessments (See Chapter 13.)
- Internal audit assistance the auditor expects to receive from the auditee (See paragraphs 4.16 and 4.17.)

Engagement Reporting Objectives

4.07 The auditor should establish an understanding with management early to determine the specific auditor's reports to be issued. For example, in

an audit conducted in accordance with GAAS, the auditor may be required to report on any or all of the following.

- The basic financial statements with accompanying RSI, as discussed in Chapter 2. The basic financial statements are the minimum financial statements that should be prepared under generally accepted accounting principles (GAAP) and, generally contain government-wide financial statements, fund financial statements, and notes to the financial statements. RSI consists of MD&A and, when applicable, other RSI.⁵
- The CAFR, which, in addition to the basic financial statements with accompanying RSI, contains:
 - An introductory section
 - Combining and individual nonmajor fund financial statements and schedules⁶
 - Statistical tables
- The financial statements of the primary government or of a component unit, department, agency, program, or individual fund

Paragraphs 4.49 through 4.56 discuss the auditor's responsibility for performing procedures on RSI and SI. Chapter 14, "Audit Reporting," discusses and illustrates the auditor's reporting on governmental financial statements.

4.08 The engagement may include audit requirements in addition to an audit in accordance with GAAS. For example, requirements could include the need to comply with *Government Auditing Standards* or the Single Audit Act Amendments of 1996 and OMB Circular A-133, as described in SOP 98-3, included as Appendix D of this Guide. The auditor should exercise care to ensure that the audit requirements of the engagement are clearly defined, preferably in writing. Because of the various audit requirements to which governments are subject, paragraph 21 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21), states that auditors should exercise due professional care to ensure that they and management understand the type of engagement to be performed. Paragraph 22 of SAS 74 states that, if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.

Principal Auditor Status and Independence

4.09 As discussed in Chapter 3, the financial statements of component units often are required to be included with the financial statements of a primary government to form the financial statements of a financial reporting entity. Frequently, that requirement results in including component units whose financial statements are audited by auditors other than the auditor

⁵ As discussed in Chapter 2, "Financial Reporting," and Chapter 11, "The Budget," GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, permits governments to elect to report required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as required supplementary information (RSI).

⁶ The auditor may be engaged to audit the combining and individual fund financial statements and schedules or instead may report on them as supplementary information other than RSI, known as SI, that accompanies the audited financial statements.

engaged by the primary government. In some cases, the assets, liabilities, revenues, or expenses/expenditures of one or more of those component units exceed those of the primary government. In addition, some primary governments may hire a separate auditor to audit separate funds, such as certain enterprise funds or a pension trust fund. Those circumstances have raised questions about the identity of the principal auditor of the reporting entity's financial statements. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543.02, "Part of Audit Performed by Other Independent Auditors"), requires a decision as to whether the auditor's participation in the audit is sufficient to enable the auditor to serve as the principal auditor and to report as such on the financial statements. At a minimum, an auditor should meet both of the following criteria to serve as the principal auditor:

- Engagement by the primary government as the principal auditor of the financial reporting entity
- Responsibility for auditing the primary government's general fund (or other primary operating fund)

4.10 Having met the principal auditor criteria, that auditor is required to exercise the responsibilities of the position as discussed in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 543.10, .12, and .13). In obtaining independence representations from other involved auditors, the principal auditor should consider the provisions of Ethics Interpretation 101-10 of the AICPA Code of Professional Conduct, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12), as discussed in paragraph 4.14. (See Chapter 3 for a discussion of the responsibilities of the component unit auditor.)

4.11 In accordance with SAS No. 1, (AU sec. 543), the principal auditor should decide whether to make reference in his or her report to the audits performed by the other auditors. Reference should be made unless the principal auditor decides to assume responsibility for the work of the other auditor. SAS No. 1, (AU sec. 543), provides guidance for making that decision, and that decision should be made in the context of the opinion unit that contains the financial statements that are audited by the other auditor. (See the discussion of materiality determinations and opinion units in a governmental audit in paragraphs 4.18 through 4.30.) Chapter 14 discusses the effect on the auditor's report when part of the audit is performed by another auditor.

4.12 Because of expertise, contracting requirements or preferences, or other reasons, an auditor occasionally performs an audit on a subcontract or joint basis or through a joint venture with another auditor, for example, a state auditor's office or a minority-owned or small firm. Auditors participating in such an arrangement should consider arriving at a formal understanding of their respective responsibilities, including the following:

- Client communication responsibilities, including general communications and communicating findings
- Reporting responsibilities, including signing the audit report (see the discussion in Chapter 14)
- Determining the compensation of the parties
- Supervising the engagement
- Documenting the engagement and ownership of audit documentation
- Establishing review procedures

The responsibility for signing the audit report usually dictates the extent of the review of audit documentation and other professional requirements imposed on the participants.

4.13 AICPA members who are engaged to audit the financial statements of governmental entities in accordance with GAAS are required to be independent. In making judgments about whether they are independent, members should be guided by Rule 101, *Independence*, of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101), its Interpretations, and the Ethics Rulings it includes.⁷ Members also should be guided by the definition of the term *client* at ET sec. 92.01, which provides that AICPA members who are employed by state and local governments who meet certain criteria may be considered independent for purposes of auditing their employer governments.

4.14 Ethics Interpretation 101-10 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12) discusses the effect on an auditor's independence of relationships with entities included in governmental financial statements. However, that Interpretation has not been updated to consider the changes in financial statement presentation resulting from GASB Statement No. 34 or the concept of opinion units described in paragraphs 4.18 through 4.30.⁸ Auditors should use professional judgment and the concepts expressed in Interpretation 101-10 to evaluate independence in relation to a primary government, parts of the primary government, component units, and other organizations disclosed in the reporting entity's financial statements until the Interpretation is updated.

4.15 Sometimes when a government audit agency performs an audit (whether as the principal auditor or under a joint arrangement with another auditor), there is a change in the administration of the audit agency (for example, as a result of an election). In some cases, the last date of field work (and thus the date of the auditor's report) may fall within the term of the outgoing government auditor. However, the financial statements, the management representation letter(s), certain communications to the auditee, and the auditor's report may not be finalized until after the incoming government auditor takes office. Even though the date of the audit report may fall within the predecessor auditor's term, the auditor in office when the report is issued should sign the report because the auditor relies on the staff of the audit agency. (Chapter 13 discusses a similar situation involving the signing of the management representation letter following a change in administration.)

The Internal Audit Function

4.16 State and local governments frequently establish an internal audit organization; large governments sometimes establish separate organizations for separate departments. The responsibilities of internal audit organizations

⁷ Effective for audits of financial statements for periods beginning on or after October 1, 2002, *Government Auditing Standards* Amendment 3, *Independence*, provides independence requirements that are more restrictive than those of the American Institute of Certified Public Accountants (AICPA). Some state boards of accountancy have independence requirements in addition to those of the AICPA.

⁸ In June 2000, the AICPA issued an Exposure Draft (ED), *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*, that proposes, among other matters, to revise Ethics Interpretation 101-10 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12). The ED is available on the AICPA website at www.aicpa.org.

can vary significantly—from monitoring control activities to providing assurance and consulting activities designed to add value and improve an organization's operations and its risk management, control, and governance processes. The internal audit organization usually attempts to maintain its independence from the executive, legislative, or judicial branches although, administratively, it may report to one or more of them.⁹ Auditors should recognize the various roles and perspectives that internal auditors may have within government and consider whether and how they may be able to use the work of those internal auditors to assist in the audits of the government's financial statements.

4.17 An internal audit function may affect an organization's internal control in two ways. First, the function usually increases the attention devoted to internal control. Second, to the extent the function is responsible for a continuing evaluation of internal control, it serves the important role of monitoring internal control. An internal audit organization also may be responsible for monitoring compliance by the entity's grantees and subgrantees with the provisions of grant agreements. Independent auditors may be able to coordinate efforts with the internal audit organization and use their efforts to provide audit evidence. SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), discusses the effects of internal audit organizations on the audit.

Materiality

4.18 This section describes how the nature of the governmental financial reporting model is the basis for how materiality is determined in an audit of governmental financial statements. It also describes how materiality determinations for purposes of preparing a government's basic financial statements differ from materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements.

4.19 As described in Chapter 2, governments generally are required to include in their basic financial statements both government-wide financial statements and fund financial statements. GASB standards require those financial statements to present certain disaggregated information. For example, GASB Statement No. 34 requires the government-wide statement of net assets and statement of activities, which display information about the government as a whole, to include separate rows and columns to distinguish between the governmental and business-type activities of the primary government and also between the primary government and its discretely presented component units. The fund financial statements are required to report additional and detailed information about the primary government's funds, including its blended component units. Separate sets of financial statements are required for each fund category—governmental, proprietary, and fiduciary—and each statement is required to present a number of different columns. For example, the governmental fund financial statements are required to present separate columns for the financial information for each major governmental fund, for the nonmajor governmental funds in the aggregate, and for total governmental funds.

⁹ Auditors employed by state and local governments sometimes may be considered independent. See paragraph 4.13.

GASB Guidance to Preparers on Materiality Determinations

4.20 Items 1 through 6 of the GASB staff document, *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A), explain how preparers should view governmental financial statements in applying materiality determinations. That view is based on the requirements in GASB standards to report separate financial statements or information for various reporting units, as shown in Exhibit 4.1. Item 1 in the 2nd GASB 34 Q&A indicates that preparers should make separate materiality evaluations for the governmental activities; the business-type activities; and each major governmental and enterprise fund because those reporting units are considered to be quantitatively material. That item also states that the components of the remaining fund information—nonmajor governmental and enterprise funds, internal service funds, and fiduciary funds—may or may not be quantitatively material. It states that the preparer's view of the data presented for those reporting units for purposes of materiality evaluations should be based on professional judgment considering relevant qualitative factors and the relationship of the remaining fund reporting units to other appropriate information in the financial statements. Item 2 of the 2nd GASB 34 Q&A indicates that materiality assessments for the reconciliations between the fund financial statements and the government-wide financial statements should be considered in conjunction with the government-wide financial statements. Note that those reconciliations are presented at the bottom of the fund financial statements or in an accompanying schedule to the statements.

4.21 Items 4 through 6 of the 2nd GASB 34 Q&A discuss how preparers should view the data for discretely presented component units for purposes of materiality evaluations. Item 5 states that assessment of major individual discretely presented component units should consider certain characteristics of the major component unit information and be based on an evaluation of the unit's significance relative to the total discretely presented component units and the nature and significance of the unit's relationship to the primary government. Item 6 states that the preparer's view of the data presented for component unit information when there are no major component units for purposes of materiality evaluations should be based on professional judgment. That judgment includes considering relevant qualitative factors and the relationship of the nonmajor component units' information to other appropriate information in the government's financial statements.

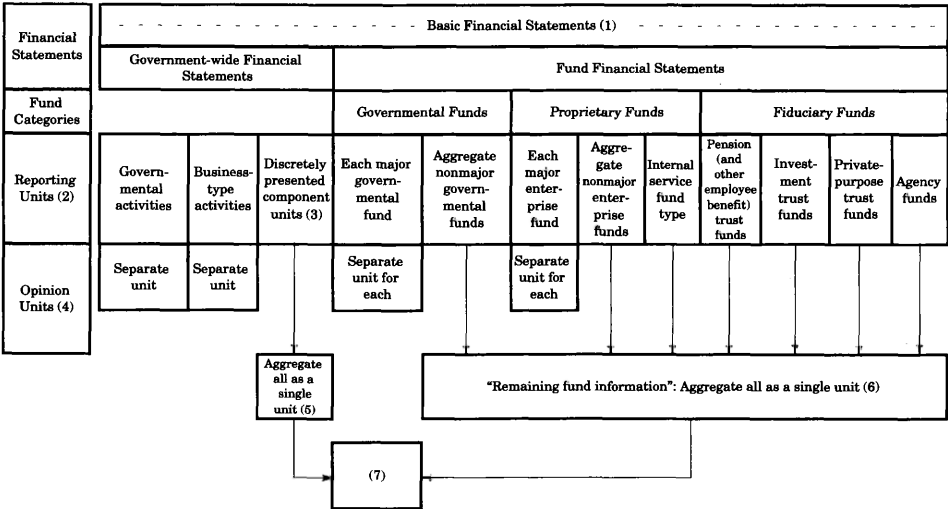
***Auditor Materiality Determinations*¹⁰**

4.22 As stated in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 312), the auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perceptions of the needs of a reasonable person who will rely on the financial statements. Auditors should refer to SAS No. 47, as amended, and its Interpretations (AICPA, *Professional Standards*, vol. 1, AU sec. 9312) for general guidance on materiality considerations. Because of the unique nature of governmental financial reporting, the auditor's consideration of whether a government's basic financial statements are presented fairly, in all material respects, in conformity with GAAP, should be based on opinion units, as shown in Exhibit 1 and as discussed in paragraphs 4.23 through 4.26.

¹⁰ Government Auditing Standards includes additional guidance on materiality. See SOP 98-3 (Appendix D of this Guide).

Exhibit 4.1

Overview of Reporting Units and Opinion Units



NOTE: GASB Statement No. 34 requires the presentation on the governmental fund financial statements of reconciliations to governmental activities in the government-wide financial statements. It also requires reconciliations on the proprietary fund financial statements from enterprise funds to business-type activities in the government-wide financial statements, if applicable. In planning, performing, evaluating the results of, and reporting on the audit, the auditor should consider the information presented in the financial statement reconciliations as relating to the governmental activities and business-type activities opinion units.

- (1) The basic financial statements also include notes to the financial statements that are essential to the fair presentation of the financial statements. Chapter 13 discusses the effect of opinion units on the auditor's evaluation of note disclosures.
- (2) Reporting units represent the separate columnar displays required by GASB standards.
- (3) Financial reporting alternatives exist for the display of discretely presented component units. See the discussion in footnote 12 and Chapter 3.
- (4) These are the opinion units required for an audit of a government's basic financial statements. An auditor may be engaged to set the scope of the audit and assess materiality at a more-detailed level than the opinion units required for the basic financial statements, as discussed in paragraphs 4.29 and 4.30.
- (5) Except as indicated in (7), auditors should make a single quantitative materiality evaluation for the aggregate discretely presented component units, and apply quantitative materiality to those component units independently of the quantitative evaluations they make for other opinion units and regardless of how major component units are reported in the basic financial statements. That quantitative evaluation along with qualitative materiality factors should affect the nature, timing, and extent of audit procedures applied to the financial information of individual component units that comprise the opinion unit. See paragraph 4.24.
- (6) Except as indicated in (7), auditors should make a single quantitative materiality evaluation for the remaining fund information, and apply quantitative materiality to that remaining fund information independently of the quantitative evaluations they make for other opinion units. That quantitative evaluation along with qualitative materiality factors should affect the nature, timing, and extent of audit procedures applied to the financial information of individual funds that comprise the opinion unit. See paragraph 4.24.
- (7) As explained in paragraph 4.25, under certain circumstances auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit referred to as the *aggregate discretely presented component unit and remaining fund information* opinion unit. Auditors should apply quantitative materiality to that combined aggregate opinion unit independently of the quantitative evaluations they make for other opinion units and regardless of how major component units are reported in the basic financial statements. That quantitative evaluation along with qualitative materiality factors should affect the nature, timing, and extent of audit procedures applied to the financial information of the individual discretely presented component units and funds that comprise the opinion unit.

4.23 Auditors should make separate materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements for each opinion unit. Except as discussed in paragraph 4.25, the opinion units in a government's basic financial statements are (as applicable) the governmental activities; the business-type activities; the aggregate discretely presented component units; each major governmental and enterprise fund;¹¹ and the aggregate remaining

¹¹ Major governmental and enterprise funds are separate opinion units regardless of whether (1) they meet the quantitative criteria in GASB Statement No. 34 for reporting as major or (2) the government voluntarily decides to report them as major because they are particularly important to financial statement users.

fund information (nonmajor governmental and enterprise funds, the internal service fund type, and the fiduciary fund types). The auditor should view the financial statement reconciliations presented at the bottom of the fund financial statements or in an accompanying schedule as relating to the presentation of the governmental activities and business-type activities opinion units. Chapters 13 and 14 discuss how the auditor should evaluate misstatements and express opinions in the auditor's report separately for each opinion unit.

4.24 Audit materiality is based on the opinion units indicated above because, as established in GASB Statement No. 34 and explained in the 2nd GASB 34 Q&A, a government's basic financial statements highlight a primary government's governmental activities, its business-type activities, and each of its major governmental and enterprise funds. As a general rule, the other information presented in a government's basic financial statements is separated into two opinion units—the aggregate remaining fund information and the aggregate discretely presented component units. Those groupings distinguish financial information for the primary government from financial information for its discretely presented component units. (See also paragraph 4.25.) The auditor should make materiality evaluations for each opinion unit separately. That is, the materiality evaluation for one opinion unit should not be affected by other information in the government's financial statements or by quantitative or qualitative factors relating to other opinion units. Also, in the audit of a government's basic financial statements, the auditor should not establish more than one opinion unit for the aggregate remaining fund information, even though, as discussed in paragraph 4.20, the 2nd GASB 34 Q&A advises preparers to consider disaggregating the remaining fund information for purposes of materiality evaluations. Similarly, auditors should not establish more than one opinion unit for the aggregate discretely presented component units, regardless of how major component units are reported in the basic financial statements.¹² (Paragraphs 4.29 and 4.30 discuss how auditors may set the scope of the audit at a more-detailed level.) However, because of the various, potentially diverse information comprising the aggregate opinion units (that is, the aggregate remaining fund information and the aggregate discretely presented component units, or the combination of those two, as discussed in paragraph 4.25), the auditor should consider how qualitative and quantitative factors relating to the components of each aggregate unit will affect the nature, timing, and extent of audit procedures on that unit. Regardless of how the auditor designs and performs audit procedures for each opinion unit (including the aggregate opinion units), the auditor's report on the basic financial statements should provide one opinion for each opinion unit, as discussed in Chapter 14.

4.25 Normally, as discussed in paragraphs 4.23 and 4.24, the aggregate discretely presented component units and the aggregate remaining fund information are treated as separate opinion units. In some cases, however, the aggregate discretely presented component unit opinion unit is not quantitatively or qualitatively material to the primary government. For example, the reporting entity may have a single, small component unit and there are no qualitative factors that make that component unit material to the primary government. In other cases, the aggregate remaining fund information opinion unit is not quantitatively or qualitatively material to the primary government.

¹² As discussed in Chapter 3, "The Financial Reporting Entity," information about each major component unit can be provided by (a) presenting each major component unit in a separate column in the government-wide financial statements, (b) including combining statements of major component units in the basic financial statements after the fund financial statements, or (c) presenting condensed financial statements in the notes to the financial statements.

For example, the primary government may have only a few, small nonmajor governmental or enterprise funds (and no internal service or fiduciary funds) and there are no qualitative factors that make those funds material to the primary government. In either of those situations, auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit for purposes of planning, performing, evaluating the results of, and reporting on the audit of the government's basic financial statements. That combined opinion unit is referred to as the “aggregate discretely presented component unit and remaining fund information” opinion unit. Even if that combined aggregate opinion unit is not material to the primary government, no further aggregation of that opinion unit with other of the government's opinion units is permitted. Similarly, no further aggregation is permitted if the government has only the aggregate discretely presented component unit opinion unit or only the aggregate remaining fund information opinion unit, and that opinion unit is not material to the primary government.

4.26 Auditors should determine opinion units for audits of a special-purpose government's basic financial statements in the same manner as for general-purpose governments.

- A government that is engaged in a single governmental program and that combines its fund financial statements and government-wide financial statements, as provided in paragraph 136 of GASB Statement No. 34, will have an opinion unit for each major governmental fund, an opinion unit for its aggregate nonmajor governmental funds, if any, and an opinion unit for the government-wide total column, which represents governmental activities.
- A government that is engaged only in business-type activities may have more than one opinion unit. For example, a utility district with more than one enterprise fund (one each for its water, sewer, electric, and trash operations) will have an opinion unit for each major enterprise fund and another opinion unit for its aggregate nonmajor enterprise funds, if any, which represents “remaining fund information.”¹³
- A government that is engaged only in fiduciary activities has only one opinion unit that represents, in effect, “remaining fund information.” For a public employee retirement system (PERS) with more than one defined benefit pension plan that presents separate financial statements for each plan, as required by GASB standards, those separate plan financial statements do not represent separate opinion units but rather are aggregated into a single opinion unit.

If a special-purpose government has one or more discretely presented component units, the component unit, or the aggregate of those component units, is an opinion unit separate from the government's other opinion unit(s), unless the aggregate component units meet the conditions for combining with the aggregate remaining fund information, as discussed in paragraph 4.25.

Quantitative and Qualitative Materiality Factors

4.27 The auditor plans the audit to obtain reasonable assurance of detecting misstatements that he or she believes could be large enough, individually

¹³ Some special-purpose governments engaged only in business-type activities report fiduciary activities in fiduciary funds. GASB Statement No. 34 does not require those governments to present a government-wide financial statement because the activity reported in fiduciary funds is not part of government-wide financial statements. In those situations, the fiduciary funds are part of the remaining fund information opinion unit.

or in the aggregate, to be quantitatively material to the financial presentation of an opinion unit. Auditors may establish a single measure or multiple measures of quantitative materiality for each opinion unit in designing and performing audit procedures. As a practical approach to establishing multiple measures of quantitative materiality for an individual opinion unit, the auditor may consider qualitative factors such as whether large-dollar activity or balances might distort quantitative materiality for the unit. For example, the governmental activities opinion unit may have significant amounts of general capital assets, including infrastructure assets that are as large as, if not larger than, all of the other assets of that opinion unit. In that case, the auditor may wish to take a two-tiered approach to establishing quantitative materiality and develop one set of measures for considering general capital asset activity and balances and another set of measures for considering activity and balances relating to other than general capital assets. Other accounts that similarly could distort quantitative materiality considerations for an opinion unit include investments, debt, and special and extraordinary items. However, as stated in paragraph 4.24, regardless of how the auditor designs and performs audit procedures for each opinion unit, the auditor's report on the basic financial statements should provide one opinion for each opinion unit.

4.28 SAS No. 47, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 312.20), states that although auditors should be alert for misstatements that could be qualitatively material, it ordinarily is not practical for auditors to design procedures to detect them. In planning the audit of a government's basic financial statements, auditors often consider qualitative factors relating to financial information that might cause quantitatively immaterial misstatements to be considered material. Some examples include possible fraud, illegal acts, and conflicts of interest; a pattern of management bias or weak internal control; and politically sensitive matters and matters that are known to be of concern to financial statement users. See the discussion of the consideration of qualitative factors in evaluating financial statement misstatements in Chapter 13.

More-Detailed Materiality Levels

4.29 Because of the terms of the audit engagement, the auditor may set the scope of the audit and assess materiality at a more-detailed level than by the opinion units required for the basic financial statements (for example, at an individual fund or fund type level). In many cases, the more-detailed level is required by legal or contractual provisions, such as state law, bond covenants, or grant or contribution agreements.

4.30 A more-detailed audit scope supplements, rather than replaces, the scope of the audit on a government's basic financial statements. That is, the auditor should continue to plan, perform, evaluate the results of, and report on the audit of the basic financial statements based on the opinion units described in paragraphs 4.22 through 4.26. The auditor also should plan, perform, evaluate the results of, and report on the entity's financial statements at the more-detailed level by establishing additional opinion units corresponding to the expanded scope. Chapter 14 discusses how a more-detailed audit scope affects the auditor's report.

Understanding the Government

4.31 The auditor should obtain background information relating to the operations of both the governmental industry and the entity to provide a basis for audit planning. Background information that may be useful to planning generally can be obtained from, for example, federal and state laws and

regulations, local charters, budget documents, recent official statements, prior-period financial reports, the request for proposal (RFP) for audit services, and discussions with key members of management. Such background information may include:

- Economic, legislative, regulatory, accounting, and auditing developments that affect the governmental industry in general and the auditee in particular¹⁴
- The composition of the reporting entity
- The form of government, for example, a governing board with an elected governor or mayor as the administrator versus a governing board with an appointed manager
- Organizational structure, including the names and experience of top management
- Laws and regulations governing the general operations of the entity
- The nature of any joint ventures
- Factors affecting the continued functioning of the government, for example, the presence or absence of taxpayer initiatives that limit its budget growth or addition of services
- The existence and functions of an audit committee or other group or individual with oversight responsibility for financial reporting
- Primary sources of revenue (for example, property taxes, appropriations from other governments, grants, contracts, and service charges)
- Services provided by the entity and the relative level of resources used for each function or program
- Involvement in complex, unusual, or risky activities
- Services provided by separate departments and independent entities (for example, hospitals, school districts, redevelopment agencies) and their relationship to the entity to be audited
- Accounting and financial reporting requirements established by another government with financial reporting oversight responsibilities
- Accounting and financial reporting policies, procedures, and systems, including the number and nature of funds, supplementary records that are maintained for capital assets (including infrastructure capital assets) and long-term debt, and the entity's methods of producing information for presentation in the government-wide financial statements from fund-based accounting data
- If accounting and financial reporting functions are automated, the types of computer equipment used, personnel involved, and similar background information, including software packages and operating systems
- Opinion modifications on prior-period financial statements that could lead to opinion modifications on the current-period financial statements
- The current status of prior-period findings¹⁵ and questioned costs in compliance audits, which could require the reporting of contingent liabilities

¹⁴ The AICPA's annual Audit Risk Alert *State and Local Governmental Developments* includes information about governmental industry developments.

¹⁵ *Government Auditing Standards* includes an additional fieldwork requirement for following up on known material findings and recommendations from previous audits. See SOP 98-3 (Appendix D of this Guide).

- The nature of any compliance auditing requirements
- Special reporting requirements

4.32 Because of legal or contractual provisions concerning confidentiality, some governments restrict an auditor's access to certain source records that support amounts that are material to the financial statements. For example, state constitution or legislation may restrict access of state income tax returns to employees of the state's revenue collection department. In such a situation, an auditor may be able to perform adequate alternative procedures to obtain sufficient competent evidential matter to achieve the audit objectives. Alternatives may include procedures performed by the internal audit organization for the auditor or substantive procedures that provide indirect evidence about the information, such as analytical procedures. The auditor should consider the guidance in SAS No. 65 (AU sec. 322) in using the work of internal auditors and SAS No. 56, *Analytical Procedures*, as amended by SAS No. 96, *Audit Documentation*¹⁶ (AICPA, *Professional Standards*, vol. 1, AU sec. 329) in performing analytical procedures.) If the auditor is not able to perform adequate alternative procedures, he or she should consider the guidance of SAS No. 58, *Reports on Audited Financial Statements*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 508). As discussed in SAS No. 58, restrictions on the scope of the audit, whether imposed by the client or by circumstances, including the inability to obtain sufficient competent evidential matter, may require the auditor to qualify the opinion or to disclaim an opinion.

Understanding Governmental Accounting and Financial Reporting Standards

4.33 Auditors should understand the unique nature of the governmental financial reporting model, as described in Chapter 2. In auditing a government's financial statements, two financial reporting concerns may include evaluating which funds are separately reported as major funds and the presentation of comparative financial information, as discussed in Chapters 2 and 14. Further, during planning, the auditor should consider whether the entity has or is required to implement new accounting and financial reporting standards, including those arising not only from GASB pronouncements but also from AICPA and Financial Accounting Standards Board (FASB) pronouncements that are applicable to the entity. (For example, certain enterprise funds, and the resulting reporting in the government-wide financial statements, might apply all of the FASB pronouncements issued after November 30, 1989, unless they conflict with or contradict GASB pronouncements, as discussed in Chapter 2.) The AICPA's annual Audit Risk Alert *State and Local Governmental Developments* often includes information about recently issued AICPA and FASB pronouncements that may be applicable to governmental entities.

Related Parties and Transactions

4.34 The auditor should evaluate the government's identification of related parties and transactions. In a governmental audit, related parties include members of the governing board, administrative boards or commissions,

¹⁶ SAS No. 96, *Audit Documentation*, amends SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), for periods beginning on or after May 15, 2002 (with earlier application permitted), by requiring certain documentation when an analytical procedure is used as the principal substantive test of a significant financial statement assertion.

administrative officials and their immediate families, component units and joint ventures, and affiliated or related organizations that are not included as part of the financial reporting entity.¹⁷ Many governments require their officials and employees to periodically file statements to disclose related-party relationships and transactions. Among other procedures, the auditor could review those disclosure statements to evaluate the government's identification of related parties and transactions. See the discussion about the financial reporting of related-party transactions in Chapter 13.

Planning Analytical Procedures

4.35 SAS No. 56, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires the auditor to use analytical procedures during audit planning to identify significant matters that may require audit emphasis.^{18, 19} Analytical procedures should be directed at a level sufficient to understand the effect of significant events or actions taken by management, which may involve individual accounts or financial statement subtotals and totals. The auditor should perform analytical procedures during audit planning for each of the financial statement's opinion units. (See the discussion of opinion units at paragraphs 4.18 through 4.30). As an analytical procedure, the auditor could compare a government's actual results to its budgets, even if the budgets are not legally required or the budgetary comparison information is not presented as a basic financial statement.

Internal Control Over Financial Reporting

4.36 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the objectives and components of an entity's internal control and explains how an auditor should consider internal control in planning and performing an audit.^{20, 21} Because an audit of government's financial statements is based on opinion units as

¹⁷ GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, amends GASB Statement No. 14, *The Financial Reporting Entity*, to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. The provisions of GASB Statement No. 39 are effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged. See the further discussion in Chapter 3, "The Financial Reporting Entity."

¹⁸ See footnote 16.

¹⁹ The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures.

²⁰ *Government Auditing Standards* includes additional guidance about internal control over financial reporting. Those standards also include an additional fieldwork requirement concerning audit documentation when assessing control risk at maximum for controls significantly dependent upon computerized information systems. See SOP 98-3 (Appendix D of this Guide).

²¹ In general, controls that are relevant to an audit of financial statements pertain to the entity's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles (GAAP) or in conformity with a comprehensive basis of accounting other than GAAP—OCBOA financial statements—as defined in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04). However, controls pertaining to operations and compliance objectives also may be relevant to a financial statement audit to the extent that they pertain to data the auditor evaluates or uses in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this Guide as *internal control over financial reporting*.

discussed in paragraphs 4.18 through 4.30, the auditor's consideration of internal control in planning and performing the audit should address each opinion unit. (See also paragraph 4.58.) The following list includes examples of unique characteristics of a government's environment and its internal control that the auditor may consider in planning and performing an audit:

- Members of senior management and the governing board are elected officials or report to elected officials and therefore often are subject to political influences.
- The governing board usually holds its meeting in public.
- The press and citizens often hold management and governing board decisions and otherwise seemingly insignificant matters up to substantial scrutiny.
- Management and governing board actions often are mandated or otherwise affected by laws, regulations, and provisions of contracts and grant agreements.
- GAAP financial statements should conform to GASB standards and governmental financial statements at times are required to conform to accounting and financial reporting requirements established by another government with financial reporting oversight responsibilities.
- Management should respond to results of audits and regulatory and grantor reviews.

4.37 In acquiring an understanding of and assessing internal control, the auditor should consider computer controls as well as the controls over the manual portions of the system. (See SAS No. 55, as amended [AICPA, *Professional Standards*, vol. 1, AU sec. 319].) Further, when an entity obtains computer or other services from another organization and if those services are part of the entity's information system, SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance to the auditor. (Also see the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, for clarifications regarding the guidance in SAS No. 70, as amended.) Such guidance includes information about the situations in which to consider the effect of the service organization's controls on user organization's controls and how to consider the effect of those controls. Governments use service organizations, for example, to invest bond proceeds and pension plan assets, to serve as third-party administrators for employee health insurance programs, to perform billing services for enterprise activities, and to collect taxes.²² SAS No. 70, as amended, requires the auditor to evaluate the significance of the controls of the service organization to those of the user organization and available information about the service organization controls. The user auditor may conclude that he or she has the means from that available information to obtain a sufficient understanding of internal control to plan the audit. Or, instead, the auditor might conclude that there is a need to obtain specific information from the service organization, to perform procedures at the service organization, or to have a service auditor perform procedures.

4.38 Often, governments maintain their accounting systems on a basis of accounting other than GAAP, such as the cash or their budgetary basis of accounting. At year-end, those governments may prepare worksheets to convert their accounting system information as needed for the basic financial

²² Sometimes services organizations are other governments. For example, counties sometimes collect property taxes for cities, towns, villages, and school districts within the county and states sometimes collect income and sales taxes for other governments within the state.

statements, rather than enter conversion data into their transaction processing systems. Auditors should understand and assess internal control over the preparation of those worksheets, particularly for significant accounts, which might include receivables, inventories, capital assets, and liabilities. (See the further discussion of this matter in paragraph 4.59.)

Financial Statement Misstatements

4.39 SAS No. 47, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 312), describes the auditor's responsibility in a GAAS audit to plan and perform the audit to obtain reasonable assurance about whether the financial statements, including note disclosures, are free of material misstatement, whether caused by error or fraud. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), expands on that discussion as it relates to fraud.²³ Paragraph 2 of Interpretation 1 of AU Section 312, *Audit Risk and Materiality* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.02), lists types of misstatements caused by error or fraud that cause financial statements not to be in conformity with GAAP. The listed misstatements include not only financial statement elements, accounts, or items that are omitted or incorrectly measured, classified, or presented, but also required disclosures that are omitted or not in conformity with GAAP.²⁴

4.40 In addition, SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), describes the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements arising from illegal acts that have a direct and material effect on the determination of financial statement amounts. It also describes the auditor's responsibility for detecting, considering the financial statement effects of, and reporting illegal acts that have a material indirect effect on the financial statements.^{25, 26, 27} SAS No. 54

²³ In February 2002, the ASB issued an ED of a proposed Statement on Auditing Standards, *Consideration of Fraud in a Financial Statement Audit*, to supersede SAS No. 82. The final standard is expected to be issued by the end of 2002. For additional details, see the Auditing Standard Board-related information on the AICPA website at www.aicpa.org.

²⁴ Footnote 5 to SAS No. 47, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 312), states that the auditor's responsibility to detect misstatements resulting from illegal acts as defined in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), as having a direct and material effect on the determination of financial statement amounts is the same as that for errors or fraud. Therefore, this Interpretation also affects the auditor's consideration of those illegal acts.

²⁵ Specifically, an audit in accordance with generally accepted auditing standards (GAAS) normally does not include audit procedures specifically designed to detect material indirect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring such possible illegal acts to the auditor's attention. The auditor should make inquiries of management concerning compliance with laws and regulations and obtain written management representations concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. The auditor need perform no further procedures in this area absent specific information concerning possible illegal acts.

²⁶ Paragraph 24 of SAS No. 54 (AICPA, *Professional Standards*, vol. 1, AU sec. 317.24), observes that an audit engagement may entail a greater responsibility for detecting illegal acts than specified under GAAS. An example would be an audit under the provisions of the Single Audit Act Amendments of 1996 and OMB Circular A-133. The auditor's responsibility for detecting illegal acts in those engagements is discussed in SOP 98-3 (Appendix D of this Guide).

²⁷ One area in which noncompliance could have a material indirect effect on the financial statements involves contractual requirements for certain municipal securities issuers to file continuing disclosure documents with certain distributing organizations as discussed in Chapter 16, "Auditor Association with Municipal Securities Filings."

defines *illegal acts* as violations of laws or governmental regulations. Although it has not been explicitly stated in SAS No. 54, the phrase *laws and governmental regulations* generally has been interpreted to implicitly include the provisions of contract and grant agreements.²⁸ Laws, regulations, and the provisions of contracts and grant agreements are referred to in this Guide as *compliance requirements*. SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801), gives general guidance on the application of SAS No. 54 in GAAS audits of governmental entities.²⁹

4.41 The auditor's consideration of financial statement misstatements is a matter of professional judgment, is influenced by his or her perceptions of the needs of a reasonable person who will rely on the financial statements, and should be based on the opinion units discussed in paragraphs 4.18 through 4.30. In planning and performing an audit to provide reasonable assurance that the financial statements for each of a government's opinion units are free of material misstatements, the auditor could consider evaluating:

- Whether the governing board, citizens, or the media exert significant pressure for favorable budgetary results
- The existence of contentious or difficult accounting matters
- Management's reputation in the governmental community
- Management's attitude, awareness, and actions concerning the control environment
- The effectiveness of overall financial controls, including whether they allow the entity to operate within approved budgets and issue timely and accurate financial reports
- Whether the entity depends on one or more individuals to operate key programs or manage the budget or financial reporting function and whether the entity has provided for appropriate segregation of duties
- The effectiveness of the organizational placement of the internal audit function (legislative versus executive branch)
- Whether grants, contributions, and appropriations from other governments that finance key programs have been reduced or eliminated
- Whether key subsidiary accounting systems produce the data needed to support financial statements
- Whether accounting systems and processes are decentralized or centralized

The auditor also should consider the nature of compliance requirements that could have a direct and material effect on the determination of financial statement amounts. See the discussion starting at paragraph 4.43.

4.42 SAS No. 82 (AU sec. 316.33–.36) and SAS No. 54 (AU sec. 317.07–.11) describe the situations in which an auditor should extend procedures when he or she has determined that a misstatement is, or may be, the result of fraud

²⁸ *Government Auditing Standards* includes an additional fieldwork requirement that specifically refers to planning the audit to provide reasonable assurance of detecting misstatements resulting from noncompliance with the provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts. See SOP 98-3 at Appendix D of this Guide.

²⁹ SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), also provides general guidance when the auditor is engaged to test and report on compliance with laws and regulations under *Government Auditing Standards* and OMB Circular A-133, which are discussed in SOP 98-3 at Appendix D of this Guide.

or becomes aware of information concerning a possible illegal act, respectively. If the auditor identifies indications of fraud or illegal acts, he or she may unilaterally extend procedures, although perhaps only enough to obtain a sense of the size of the matter. If the auditor decides that extending procedures is required but cannot come to mutually agreeable terms with the government, that situation should be considered a restriction on the scope of the audit, which may require the auditor to qualify the opinion, to disclaim an opinion, or to withdraw from the engagement. SAS No. 82 and No. 54 provide guidance on those alternative courses of action.

Financial Statement Compliance Requirements

4.43 An entity's management is responsible for ensuring compliance with the laws, regulations, and provisions of grants and contracts applicable to its activities. That responsibility encompasses identifying applicable compliance requirements and establishing internal control designed to provide reasonable assurance that the entity complies with them. Governments are established by and operate under numerous laws and regulations, and they generally are subject to many more legal constraints than are nongovernmental entities. National Council on Government Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 5, recognizes that compliance requirements may affect governmental financial statements:

An important aspect of GAAP as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are reflected in the fund structure, bases of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting.

4.44 As discussed in paragraph 4.40, GAAS require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements arising from illegal acts that have a direct and material effect on the determination of financial statement amounts. The following types of compliance requirements may have such an effect on financial statement amounts. To understand these and other compliance matters within the scope of the audit, the auditor should consider seeking guidance from auditee officials, officials of other levels of government with oversight responsibility, and legal counsel.

- **GAAP Requirements.** Governments often are subject to legal or contractual provisions that require them to prepare their financial statements in conformity with GAAP.
- **Federal and State Taxes.** Governments are subject to various federal tax requirements, including those relating to employment taxes, employee benefits, and tax-exempt debt (such as arbitrage rebate requirements). State-level tax requirements also may apply.
- **Legal Authority for Transactions.** Governments often should have legal authority to execute transactions. That is, governments, especially local governments, often cannot exercise powers or conduct activities unless authorized by law. For example, a local government may not be able to levy property taxes unless specifically authorized to do so under state law and taxes levied without proper authority may be subject to refund.
- **Establishment of Funds.** As discussed in Chapter 2, legal and contractual provisions may require governments to establish individual funds to account for and report on particular activities.

- *Time and Other Eligibility Requirements and Purpose Restrictions on Nonexchange Transactions.* Time and other eligibility requirements and purpose restrictions affect the recognition and reporting of nonexchange transactions. A government's failure to comply with a provider's eligibility requirements and purpose restrictions may cause the provider to withdraw the intended support or request a refund of amounts previously paid. For example, certain costs are not allowable costs for federal programs under Office of Management and Budget (OMB) Circular No. A-87, *Cost Principles for State and Local Governments*, but they may have been inappropriately charged to those programs. Similarly, legal provisions may restrict a government's use of its tax revenues (such as a constitutional requirement that the proceeds of a state gasoline tax be expended only for the maintenance of highways).
- *Other Legal- and Contract-Based Compliance Requirements.* Besides the eligibility requirements and purpose restrictions that affect the recognition and reporting of nonexchange transactions, providers of such resources may impose other compliance requirements on recipients. For example, federal financial assistance programs often require recipients to adhere to specific procurement and cash management policies. There also may be contractual compliance requirements relating to exchange transactions, such as those discussed below for debt issuances.
- *Budgets.* Budgets often establish the particular funds that can finance particular costs and the nature and amount of interfund activity.
- *Tax and Debt Limitations.* Governments often are subject to legal provisions that limit taxing authority, impose ceilings and other issuance requirements on debt, or limit the use of debt proceeds to particular purposes. For example, state law may impose a millage cap on property taxes or require tax refunds if an entity's annual revenue growth exceeds a set percentage or amount. Also, debt often is issued subject to contractual provisions that require certain reserve fund and revenue coverage amounts.

The compliance requirements listed above may not have a direct and material effect on the determination of financial statement amounts for all governmental entities. Further, there may be types of compliance requirements other than those included here for which noncompliance could have a direct and material effect on the determination of financial statement amounts.

4.45 Governments often are affected by many other laws or regulations, including those related to occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. SAS No. 54 states that those laws and regulations generally relate more to an entity's operating aspects than to its financial and accounting aspects, and that the financial statement effect of those laws and regulations is indirect. Although SAS No. 54 does not require the auditor to *plan* the audit to detect noncompliance with such compliance requirements, the auditor does have certain detection, consideration, and reporting responsibilities. (See paragraph 4.40 and footnote 25.) Because GAAP require governments to disclose material violations of finance-related legal and contractual provisions (see paragraph 4.48), the auditor of a governmental entity should be alert to the possible financial reporting effect of noncompliance that has a material indirect effect on financial statements. However, even though a violation of such legal and contractual provisions can have consequences that

are material to the financial statements, the auditor may not become aware of the violation unless informed of it by the entity or there is evidence of the violation in the documents the auditor normally inspects during the audit.

4.46 In considering whether the financial statements are free of material misstatements arising from illegal acts that have a direct and material effect on the determination of financial statement amounts, the auditor should consider both quantitative and qualitative factors. Qualitative factors that the auditor may consider relevant to that evaluation include the following.

- The potential effect of the noncompliance on the government's ability to raise resources (for example, through taxes, grants, contributions, or debt or loan financings) in the future
- The potential effect of the noncompliance on the continuation of existing relationships with vendors, employees, and elected and appointed officials
- Whether the noncompliance involves collusion or concealment
- Whether the noncompliance involves an activity that often is scrutinized by elected or appointed officials, citizens, the press, creditors, or rating agencies
- Whether the fact of the noncompliance is unambiguous rather than a matter of judgment
- Whether the noncompliance is an isolated event or instead has occurred with some frequency
- Whether the noncompliance results from management's continued unwillingness to correct internal control weaknesses
- The likelihood that similar noncompliance will continue in the future
- The cost-benefit of establishing internal control to prevent similar noncompliance in the future
- The risk that possible undetected noncompliance would affect the auditor's evaluation

4.47 The auditor may consider performing the following procedures to assess management's identification of compliance requirements that could have a direct and material effect on the determination of financial statement amounts:

- Consider knowledge about compliance requirements obtained during prior-period audits.
- Interview the entity's chief financial officer, legal counsel, or grant administrators about compliance requirements.
- Identify sources of revenue, review any related agreements (for example, loan, grant, and contribution agreements), and ask about legal provisions that relate to using and accounting for the revenue.
- Obtain and review federal and state publications pertaining to compliance requirements, such as Department of the Treasury and Internal Revenue Service laws and regulations (concerning the calculation and reporting of arbitrage rebates and refunds and employment taxes) and OMB's cost principles and administrative requirements circulars and *OMB Circular A-133 Compliance Supplement*, the *Catalog of Federal Domestic Assistance*, and similar state program publications (concerning grants and appropriations).
- Obtain and review sections of the state constitution, statutes, and regulations that pertain to the entity, in particular the sections that concern financial reporting, investment, debt, taxation, budget, appropriation, and procurement matters.

- Review the minutes of meetings of the entity's governing board for the enactment of relevant laws and regulations and information about relevant contracts and grant agreements.
- Ask federal, state, or local auditors or other appropriate audit oversight organizations about applicable compliance requirements, including statutes and uniform reporting requirements.
- Ask the audit, finance, or program administrators of other entities from which the entity receives grants, contributions, and appropriations about the restrictions, limitations, terms, and conditions under which the amounts were provided.
- Review the discussions of compliance requirements applicable to specific industries, as found in this Guide and other relevant AICPA Audit and Accounting Guides (see Chapter 1, "Overview and Introduction").
- Review accounting and auditing materials available from other professional organizations, such as state societies of certified public accountants and industry associations.
- Obtain written management representation regarding the completeness of management's identification of compliance requirements.

To obtain information about possible violations of compliance requirements, the auditor should consider making inquiries of management, legal counsel, grant administrators, and other appropriate sources; and testing transactions for adherence with compliance requirements. The auditor also should obtain management's written representations about violations and possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, as required by SAS No. 85, as amended (AU sec. 333).

4.48 GASB standards require governments to disclose certain violations of compliance requirements. NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4, states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions.³⁰ Other GASB standards expand on that requirement by requiring disclosure concerning noncompliance with specific finance-related legal and contractual provisions. For example, GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires governments to disclose significant violations during the reporting period of legal or contractual provisions for deposits and investments. In addition, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, requires disclosure of actions taken to address significant violations of finance-related legal or contractual provisions. The auditor should consider the adequacy of the government's disclosures about those violations within the context of the auditor's responsibilities established in GAAS concerning illegal acts.

Required Supplementary Information and Supplementary Information

4.49 As discussed in Chapter 2, a government's basic financial statements always should be accompanied by MD&A and frequently may be accompanied

³⁰ In addition, material violations, or potential violations, of finance-related legal and contractual provisions should be considered for recording a loss contingency. Loss contingencies are discussed in Chapter 8, "Expenses/Expenditures and Liabilities."

by various types of other information presented outside the basic financial statements. Information that the GASB and the FASB require accompany the basic financial statements is RSI.³¹ GASB-required supplementary information includes, for example, MD&A, certain pension funding information, and budgetary comparison information. Information that the GASB does not require accompany the basic financial statements is SI and includes, for example, a letter of transmittal and other introductory information, combining and individual nonmajor fund financial statements and schedules, and statistical data. Governments provide SI voluntarily to supplement and expand upon the basic financial statements. RSI differs from SI because the GASB considers RSI an essential part of financial reporting and has established authoritative guidelines for measuring and presenting that information.

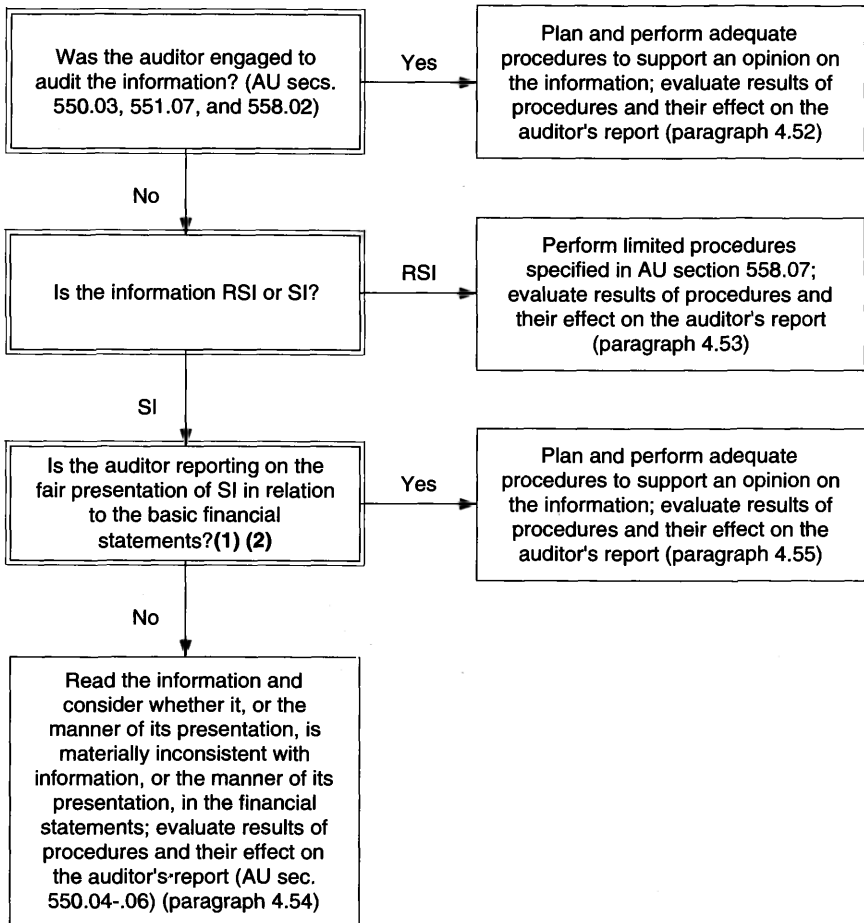
4.50 Unless the auditor is engaged to audit and express an opinion on information that accompanies the basic financial statements as discussed in paragraph 4.52, the procedures that an auditor applies to that information depends on whether it is RSI or SI. In addition, the procedures that an auditor applies to SI depends on the required auditor reporting on the SI, which can differ for client-prepared and auditor submitted documents. Procedures relating to RSI are discussed in paragraph 4.53; procedures relating to SI are discussed in 4.54 through 4.56. In addition, Chapter 16, "Auditor Association with Municipal Securities Filings," discusses the auditor's responsibilities for information that accompanies the basic financial statements in official statements. Chapter 14 discusses auditor reporting on RSI and SI. As discussed in Chapter 14, auditor reporting on RSI and SI does not affect the auditor's *opinion* on the basic financial statements. However, an auditor may have to or choose to add one or more paragraphs to his or her report concerning RSI or SI.

4.51 Exhibit 4.2 presents a flowchart that summarizes the procedures that should be performed on RSI and SI under different conditions. If the terms of the engagement provide for only some of the RSI or SI to be audited, the auditor should consider the flowchart separately for the RSI and SI that is to be audited and the RSI and SI that is not to be audited.

³¹ At present, the Financial Accounting Standards Board (FASB) has no RSI requirements that affect governmental entities. Future FASB-established RSI, if any, would be applicable to only those enterprise funds and business-type activities that apply post-November 30, 1989 FASB standards that do not conflict with or contradict GASB standards.

Exhibit 4.2

RSI and SI Procedures



(1) SAS No. 29 (AU sec. 551) requires the auditor to report on SI in an auditor-submitted document by including either an opinion on whether the SI is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion. In addition, a government may engage an auditor to report on SI in a client-prepared document using the provisions of SAS No. 29 (see paragraph 4.56).

(2) AU section 551.06 indicates that an auditor may express an opinion on a portion of SI and disclaim an opinion on the remainder.

Audit Scope Includes Required Supplementary Information or Supplementary Information

4.52 The auditor may be engaged to render an opinion on whether either or both RSI and SI are fairly presented, in all material respects, in conformity with GAAP. Before accepting such an engagement, the auditor should determine that the information is financially oriented so that it is possible to express an opinion on it. Information that is not financially oriented is subject to the AICPA standards for attestation engagements. See Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT secs. 101–701). When engaged to audit RSI or SI, the auditor should plan and perform adequate procedures and evaluate the results of those procedures to support developing an opinion on the information or to disclaim an opinion. The auditor makes materiality determinations and establishes opinion units for planning, performing, evaluating the results of, and reporting on the results of the audit depending on the terms of the engagement. For example, if the engagement terms provide for the audit of each fund presented in combining and individual nonmajor fund financial statements, the auditor should consider each fund to be a separate opinion unit.

Required Supplementary Information

4.53 The auditor's responsibilities for performing procedures and reporting on RSI are provided in SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AICPA, *Professional Standards*, vol. 1, AU sec. 558, "Required Supplementary Information").³² The auditor should consider what RSI is required by the GASB in the circumstances. If RSI is required, the auditor ordinarily should apply the following limited procedures to the information, as required by SAS No. 52 (AICPA, *Professional Standards*, vol. 1, AU sec. 558.07):

- Inquire of management about the methods of preparing the information, including (a) whether it is measured and presented within prescribed guidelines,³³ (b) whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes, and (c) any significant assumptions or interpretations underlying the measurement or presentation.
- Compare the information for consistency with (a) management's responses to the foregoing inquiries, (b) audited financial statements, and (c) other knowledge obtained during the examination of the financial statements.
- Consider whether representations on RSI should be included in specific written representations obtained from management. See SAS No. 85, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 333).

³² An auditor may be engaged to render an opinion whether RSI (for example, budgetary comparison information) is fairly stated, in all material respects, in conformity with GAAP. When so engaged, the provisions of SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AICPA, *Professional Standards*, vol. 1, AU sec. 558, "Required Supplementary Information"), do not apply. Instead, the auditor should follow the guidance in paragraph 4.52.

³³ Management inquiry should address not only whether all required information is presented, but also whether nonrequired information is presented. As discussed in Chapter 2, if a government presents nonrequired information as part of RSI, the auditor should consider whether to report that the RSI content constitutes a presentation that departs materially from prescribed guidelines.

- Apply additional procedures, if any, that other [AICPA] statements, interpretations, guides, or statements of position prescribe for specific types of RSI.³⁴
- Make additional inquiries if application of the foregoing procedures causes the auditor to believe that the information may not be measured or presented within applicable guidelines.

Supplementary Information

4.54 The auditor's responsibilities with regard to SI are provided in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550).³⁵ An auditor has no obligation to perform any procedures to corroborate the information. However, the auditor should read the information and consider whether it, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. SAS No. 8 (AU sec. 550.04–.06) provides guidance if the auditor concludes there is a material inconsistency or a material misstatement of fact that is not a material inconsistency. (Additional responsibilities apply if the SI is presented in an auditor-submitted document, as discussed in paragraph 4.55, or if the auditor is engaged to or chooses to report on the SI in a client-prepared document in relation to the government's basic financial statements taken as a whole, as discussed in paragraph 4.56.)

4.55 SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended by SAS No. 52 (AICPA, *Professional Standards*, vol. 1, AU sec. 551), provides additional guidance relating to SI in an auditor-submitted document.³⁶ SAS No. 29, as amended, requires the auditor to report on all the information included in an auditor-submitted document, including either an opinion on whether the SI is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements.³⁷ Unless required to do so by the audit engagement, the auditor has no obligation to apply auditing procedures to SI, in which case he or she will disclaim an opinion on that information. (Note, however, that the auditor still has to read the information and consider its consistency in relation to the basic financial statements as discussed in paragraph 4.54.) An opinion on whether the SI is fairly stated in all material respects in relation to the basic financial statements taken as a

³⁴ At present, there are no such additional procedures prescribed by AICPA literature for governmental RSI.

³⁵ An auditor may be engaged to render an opinion regarding whether SI (for example, combining and individual nonmajor fund financial statements) is fairly stated, in all material respects, in conformity with GAAP. When so engaged, the provisions of SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 551), do not apply. Instead, the auditor should follow the guidance in paragraph 4.52.

³⁶ AICPA standards do not define when a document is auditor submitted or client prepared and leave that decision to professional judgment.

³⁷ As discussed in SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551.11), SI comprising nonaccounting information and certain accounting information not directly related to the basic financial statements ordinarily would not have been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, the auditor ordinarily would disclaim an opinion on it.

whole³⁸ would be possible if the audit of the basic financial statements encompasses the information presented in the SI or if the auditor modifies or redirects procedures to be applied in the audit of the basic financial statements so as to express such an opinion on the SI. The procedures the auditor performs should consider the relationship of the SI to relevant information in the basic financial statements. For example, information in combining nonmajor governmental fund financial statements should be related to the presentation of the aggregate nonmajor governmental funds in the basic financial statements. A schedule of insurance could be related to the insurance expense/expenditure charges in the various financial statements. In addition, the auditor should be satisfied that the SI is suitably titled.

4.56 Although the scope of SAS No. 29 does not include client-prepared documents, auditors often are engaged to use that standard to report on some or all of the SI that accompanies financial statements in a client-prepared document. If so engaged, auditors are required to include either an opinion on whether that SI is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, using the guidance of SAS No. 29.³⁹ If an “in relation to” opinion is to be given, appropriate procedures should be performed on the SI as discussed in paragraph 4.55. If the auditor is not engaged to report on SI, the auditor may choose to issue a disclaimer of opinion on the SI or ask the government to label the SI as unaudited.

Audit Approach and Program

4.57 Auditors should consider planning and performing a financial statement audit to achieve maximum audit efficiency. Because governments often maintain numerous funds, audit tests are most efficient if they are designed to avoid repetitive procedures. However, if the government operates one or more activities separately or autonomously, the auditor may need to perform procedures on those activities separately.

4.58 Many auditors plan and perform audit work based upon an entity’s transaction cycles. For example, an auditor may plan and perform audit procedures relating to an entity’s revenue and receivables by examining the cash receipts cycle. While planning and performing cycle work, the auditor should ensure that appropriate coverage is given to each opinion unit. If a government’s internal control for a transaction cycle is handled by the same system regardless of where the transactions and balances are reported in the financial statements, the auditor’s consideration of internal control and assessment of control risk for that system would apply equally to all affected opinion units, even if transactions and balances reported in an individual opinion unit are not included in a test of controls. However, in designing substantive tests of financial statement assertions, the auditor should use professional judgment in designing audit procedures that will provide appropriate substantive evidence for the auditor’s separate opinion on each opinion unit.

³⁸ As discussed in Chapter 14, “Audit Reporting,” an opinion on whether SI is fairly stated in all material respects is made in relation to the basic financial statements taken as a whole, not in relation to individual opinion units.

³⁹ Often, the terms of an engagement require the auditor to report only on SI that is financially oriented; in those situations, the auditor can express an opinion on that SI. However, sometimes the terms of an engagement require the auditor to report on all SI, including letters of transmittal and other introductory information and statistical data, which typically include information that is not financially oriented. For SI that is not financially oriented, the auditor cannot express an opinion and should disclaim an opinion.

4.59 Many governments maintain their primary accounting records based on funds and typically use a process through which they separately develop the additional information needed for the government-wide financial statements. As a result, the auditor may find it efficient to plan and perform the audit by considering the fund financial statements first and then the additional information developed for the government-wide financial statements. While much of that additional information is displayed in the reconciliations between the fund financial statements and the government-wide financial statements (such as capital asset and long-term debt information and asset and liability accruals), some additional information is not displayed in the reconciliations (such as the eliminations and reclassifications of internal activity and classifications of program and general revenues). In planning and performing the audit in this manner, the auditor should consider the different processes and internal control over the additional information developed for the government-wide financial statements. The auditor's responsibility for considering the processes and internal control over the additional information developed for the government-wide financial statements is the same as his or her responsibility for considering the processes and internal control over the fund financial statements.

Other Matters

4.60 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended by SAS No. 78 and SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance in identifying and reporting internal control-related conditions observed during a financial statement audit to the audit committee. In organizations that do not have an audit committee, the reporting is made to individuals with a level of authority and responsibility equivalent to an audit committee, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. (For governments that do not have an audit committee, the equivalent would likely be a finance committee or the entity's governing board.) In addition to providing guidance on communicating reportable conditions and identifying material weaknesses in the internal control over financial reporting, SAS No. 60 states that because timely communication may be important, the auditor may choose to communicate significant matters related to internal control over financial reporting during the course of the audit rather than after the audit is concluded. See also Chapter 13 for a discussion of SAS No. 61, *Communication With Audit Committees*, as amended [AICPA, *Professional Standards*, vol. 1, AU sec. 380).

4.61 Ethics Ruling No. 102, *Member's Indemnification of a Client* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.204 and .205) states that auditors should not enter into agreements that would require them to indemnify their client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts. To do so would impair the auditor's independence. Governments often include such clauses in RFPs for audit services and proposed audit contracts. Therefore, auditors should carefully review RFPs and proposed audit contracts for such clauses to ensure that they are not agreeing to such provisions.

4.62 SAS No. 96 (AU sec. 339) requires the auditor to adopt reasonable procedures to prevent unauthorized access to the audit documentation. An Interpretation of AU section 339 entitled *Providing Access to or Copies of Audit Documentation to a Regulator* (AICPA, *Professional Standards*, vol. 1, AU sec.

9339), provides guidance on responding to requests by governmental agencies (regulators) that auditors provide them with access to audit documentation.⁴⁰ Auditors should consider discussing this requirement with the auditee, or including it in the engagement letter.⁴¹

⁴⁰ This Interpretation was revised in January 2002 as a result of the issuance of SAS No. 96 and will become effective when SAS No. 96 becomes effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. The previous version of the Interpretation, entitled "Providing Access to or Photocopies of Working Papers to a Regulator," is available in *Professional Standards* at AU section 9339A.

⁴¹ *Government Auditing Standards* includes an additional fieldwork requirement concerning working paper requirements. That requirement specifies, among other things, that working papers (which is a term that SAS No. 96 permits to be used to refer to audit documentation) should contain sufficient information to enable an experienced third-party auditor to ascertain from them the evidence that supports the auditors' significant conclusions and judgments and that the contractual arrangements for the audit should provide for working paper access to other auditors. See SOP 98-3 (Appendix D of this Guide).

Chapter 5

Cash, Investments, and Investment-Related Activity

Nature of Transactions

5.01 Governments have certain unique accounting and financial reporting standards that apply to their cash, investments,¹ and investment-related transactions, such as reverse repurchase agreements and securities lending transactions. Those standards arise primarily from:

- Governmental Accounting Standards Board (GASB) Statements No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*; No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*; No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*; No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*; and No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*
- GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements*
- GASB Technical Bulletins (TBs) No. 87-1, *Applying Paragraph 68 of GASB Statement 3*; No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*; and No. 97-1, *Classification of Deposits and Investments into Custodial Credit Risk Categories for Certain Bank Holding Company Transactions*.
- GASB staff documents:
 - *Guide to Implementation of GASB Statement No. 3 on Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements: Questions and Answers* (GASB 3 Q&A)
 - *Guide to Implementation of GASB Statement No. 9 on Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting: Questions and Answers* (GASB 9 Q&A)²
 - *Guide to Implementation of GASB Statements 25, 26, and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers: Questions and Answers* (GASB 25, 26, and 27 Q&A)

¹ Investments are securities and other assets acquired primarily for the purpose of obtaining income or profit. This chapter does not apply to securities or other assets if they are not held by the government for investment purposes, either for the government itself or for parties for which the government serves as investment manager or other fiduciary.

² Note that the GASB staff document, *Guide to Implementation of GASB Statement No. 9 on Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting: Questions and Answers* (GASB 9 Q&A) was issued before GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. Thus, the GASB 9 Q&A includes some out-of-date information about the statement of cash flows.

- *Guide to Implementation of GASB Statement No. 31 on Accounting and Financial Reporting for Certain Investments and for External Investment Pools: Questions and Answers (GASB 31 Q&A)*

Deposit and Investment Risk

5.02 Like any entity, when a government places deposits with a financial institution or invests to earn a return, it exposes those amounts to risk—the probability or possibility of loss. Many of the GASB’s cash and investment note disclosure standards are based on the objective of providing information about the risks of potential loss of resources. Following are four basic types of deposit and investment risks that underlie those disclosure standards—credit, market, legal, and liquidity risk:

- *Credit risk.* The risk that a counterparty to a deposit or investment transaction will not fulfill its obligations. Credit risk can be associated, for example, with the issuer of a security (known as *issuer credit risk*) or with a financial institution holding deposits or a party holding securities or collateral (known as *custodial credit risk*).
- *Market risk.* The risk that the fair value of an investment or collateral protecting a deposit or investment will decline.
- *Legal risk.* The risk that a deposit or investment transaction is prohibited by law, regulation, or contract.
- *Liquidity risk.* The risk that a government’s cash may be tied up in a deposit or investment longer than it intended, or that a government will have to sell an investment before it matures or while the investment’s fair value is in decline.

Compliance Requirements and Investment Policies

5.03 Governments usually have extensive legal and contractual provisions relating to their cash, investments, and investment-related transactions, which often differ for different funds. Those requirements usually involve the types of investments and investment-related transactions a government may use (see paragraph 5.04), the counterparties with which it may conduct business, and the collateral it should obtain on depository accounts (see paragraph 5.05). Compliance requirements also arise from Internal Revenue Code (IRC) and U.S. Treasury regulations on the amount of investment income a government may earn on proceeds from tax-exempt debt without having to rebate excess earnings to the federal government, known as *arbitrage requirements*. Arbitrage requirements are discussed in paragraph 5.06.

5.04 Governments establish investment policies based on compliance requirements and other considerations (such as cash-flow needs), and often document those policies in writing. Those policies often establish stated or implied investment objectives that include safety, liquidity, and yield. To help management adhere to those objectives, investment policies often list, among other things, the types of investments that are permitted or prohibited. For some funds, such as pension trust and permanent funds, compliance requirements and investment policies may establish a “prudent person rule” rather than a “legal list” of permitted or prohibited investment types. Governments sometimes invest in sophisticated investments, including derivatives and similar investment transactions. GASB TB 94-1 defines a derivative generally as a contract whose value depends on or derives from the value of an underlying asset, reference rate, or index. Similar investment transactions include structured financial instruments, such as mortgage-backed securities. At times, the

use of derivatives and similar investment transactions is inconsistent with a particular government's compliance requirements, investment policies, or investment objectives.

Collateralization of Deposits

5.05 Legal provisions often require financial institutions to collateralize governments' cash deposits when they exceed the amount of depository insurance. Those legal provisions usually specify the type and ratio or dollar amount of collateral that is required. That collateral protects governmental deposits against the financial failure of an institution. Individual financial institutions in some states and groups of financial institutions in other states are permitted to pledge collateral on a pooled basis to cover the combined accounts of all of their governmental depositors. See GASB Statement No. 3, as amended, and the GASB 3 Q&A for a discussion of common provisions and management issues relating to the pledging of collateral on deposits with financial institutions.

Arbitrage Requirements

5.06 Arbitrage is the excess profit earned from the investment of tax-exempt bond proceeds in taxable obligations at a yield that is materially higher than the yield on the bonds. Arbitrage requirements arising from the IRC and U.S. Treasury regulations generally require governments to rebate the excess investment earnings to the federal government. For this purpose, tax-exempt debt includes bonds and certain capital leases and installment purchases. Arbitrage requirements provide guidance with respect to various aspects of the calculation of an arbitrage rebate liability, including certain exceptions that may apply if debt proceeds are spent rapidly enough and for debt issuances under certain amounts. Excess earnings are required to be rebated every five years or upon maturity of the bonds, whichever is earlier. Governments generally should calculate the arbitrage liability annually to determine whether it is material and thus should be reported in the financial statements.

Internal Investment Pools

5.07 Governments commonly combine the cash and investments of several funds to enhance investment opportunities, operating efficiency, and physical custody and control. Those arrangements are known as internal investment pools. In some cases, internal pooling of cash and investments is prohibited by compliance requirements. For example, a bond indenture may prohibit combining the cash of a sinking fund with that of other funds. In other cases, the use of an internal investment pool is not possible because different types of investments are authorized for different funds or because different funds have different investment objectives. For example, a pension trust fund may be able to enter into long-term investments whereas the general fund may not be.

Reverse Repurchase Agreements and Securities Lending Transactions

5.08 As part of their investment programs, some governments enter into reverse repurchase agreements and securities lending transactions. A reverse repurchase agreement is an agreement in which a government transfers securities to a broker-dealer or other entity for cash and simultaneously agrees to repay the cash plus interest in exchange for the same securities or for different securities in the future. A securities lending transaction is an agreement in which a government transfers its securities to a broker-dealer or other

entity for collateral—which may be cash, securities, or letters of credit—and simultaneously agrees to return the collateral for the same securities in the future. Depending on the nature of the collateral, the government may receive from or pay to the other party a fee for the securities lending transaction.

Investment Arrangements, Including External Investment Pools

5.09 Governmental officials may conduct investment activity directly with brokers or financial services companies, or they may use investment advisers and managers to varying degrees. The approach used often is affected by the size and complexity of an entity's portfolio and the knowledge and experience of its investment personnel.

5.10 Governments often enter into cooperative investing agreements with other governments, or they place their moneys with the officials of other governments (such as state or county treasurers) for individual investing or for pooled investing with moneys from other governments. Governments also sometimes enter into agreements with nongovernmental investment managers for pooled investing with other of the managers' clients (for example, collateral pools on securities lending transactions). Those cooperative or pooled investment arrangements are known as *external investment pools*; those sponsored by individual state or local governments or jointly by more than one government are known as *governmental external investment pools*.

5.11 A government's relationships with investment counterparties usually are governed by written agreements that address appropriate matters, including, for example, the types of investments that are permissible; the procedures for making each type of investment; the procedures for the custody of the evidence of the investment; and the fees to be paid for the services provided. Also, agreements that govern external investment pools usually provide for the manner in which income, losses, and expenses will be shared and the circumstances under which each participant may redeem or liquidate its interest in the pool.

Records and Supporting Documentation

5.12 For internal control and accountability purposes, governments usually maintain detailed records and supporting documentation for their cash, investments, and investment-related transactions. Some depository institutions do not return original canceled checks to their customers. Instead, they use various methods of check imaging—processes of returning images of canceled check on, for example, microfiche, compact disk, or other storage mediums. In some jurisdictions, compliance requirements may not have kept up with such banking practices and instead require the government to obtain and retain the original canceled checks.

5.13 Some governments, especially small and special-purpose governments such as single-employer pension plans, may rely exclusively or almost exclusively on investment managers to make investment decisions (within established policies), conduct investment transactions, and arrange for custody of investment securities. In those cases, the government may not maintain detailed investment records or information beyond the summary information provided to them by their investment manager or custodian.

Additional Information About Investments and Investment Risks

5.14 GASB Statement No. 3, as amended, describes the nature and types of many cash, investment, and investment-related transactions, including

repurchase agreements, and the risks associated with them. The AICPA's Audit and Accounting Guide *Banks and Savings Institutions* also discusses the nature of and risks associated with various types of investments.³

Accounting and Financial Reporting Considerations

5.15 GASB standards provide specialized investment accounting and financial reporting standards for defined benefit pension plans, reverse repurchase agreements, and securities lending transactions. See paragraphs 5.40–5.43 for a discussion of those specialized standards. GASB standards also provide specialized investment accounting and financial reporting standards for governmental external investment pools; see Chapter 12, “Special-Purpose and State Governments,” for a discussion of those standards.

Accounting

5.16 Table 5.1 shows the GASB Statements that establish investment accounting standards for various governmental financial statements. The table also indicates the paragraphs in this section that discuss additional investment accounting guidance for those financial statements.

Table 5.1

GASB Statements With Investment Accounting Standards

	<u>GASB Statement No.</u>			<u>Additional Guidance</u>
	<u>10</u>	<u>25</u>	<u>31</u>	
Government-wide (including activities that represent nonfiduciary special-purpose entities)				5.23
Governmental funds	—	—		5.21
Proprietary funds (except funds that represent public entity risk pools)	—	—		5.23
Fiduciary funds (except funds that represent governmental external investment pools and public employee pension systems)	—	—		—
Special-purpose entities				
Public entity risk pools			—	5.23
Governmental external investment pools	—	—		—
Public employee pension systems	—			—
Colleges and universities	—	—		—

5.17 The GASB 31 Q&A, item 66, states that investment transactions should be accounted for based on the trade date. The trade date is the date on which the government is exposed to (or released from) the rights and obligations of the ownership of the instrument.

³ The accounting and financial reporting guidance in the AICPA Audit and Accounting Guide *Banks and Savings Institutions* does not constitute category (b) accounting and financial reporting guidance for governmental entities because the AICPA did not make that Guide applicable to governmental entities and the GASB did not clear it. See Chapter 1, “Overview and Introduction,” for a discussion of the GAAP hierarchy for governments. Also, even though that Guide is not applicable to governmental entities, auditors should consider referring to it for specific auditing considerations relating to cash and investments. Note that the AICPA anticipates publishing, in late 2002, the Audit and Accounting Guide *Financial Institutions*, which will combine and redraft chapters from the existing AICPA Guides for *Banks and Savings Institutions*, *Credit Unions*, and *Finance Companies*.

5.18 GASB standards require that governments report many of their investments at fair value, but permit or require cost-based measures for certain investments and in certain circumstances. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. GASB Statement No. 31, paragraph 13, requires that all investment income, including changes in the fair value of investments, be recognized as revenue. Interest income on investments reported at fair value should be measured at the investment's stated interest rate; any purchased premiums or discounts on such debt securities should not be amortized or accreted to investment income.

5.19 For governments other than governmental external investment pools and defined benefit pension plans, GASB Statement No. 31, as amended, requires investments in the following to be reported at fair value: (a) interest-earning investment contracts, (b) external investment pools, (c) open-end mutual funds, (d) debt securities, and (e) equity securities, option contracts, stock warrants, and stock rights that have readily determinable fair values. However, one exception to that reporting requirement involves certain money market investments and participating interest-earning investment contracts, which may be reported at amortized cost. For purposes of that exception, the money market investments and participating interest-earning investment contracts should have a remaining maturity of one year or less at time of purchase, and the fair value of those investments should not be significantly affected by the impairment of the credit standing of the issuer or by other factors. GASB Statement No. 31, as amended, also provides guidance for reporting the fair value of investments in securities that are subject to purchased put and written call option contracts.

5.20 GASB Statement No. 31, as amended, does not apply to investments in equity securities that are accounted for under the equity method, as provided for in Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, or to investments in joint ventures or component units as provided in GASB Statement No. 14, *The Financial Reporting Entity*, as amended.

5.21 Other than investments that are within the scope of GASB Statement No. 31, as amended, the GASB has not addressed the valuation or recognition of investments reported in governmental funds. (For example, although rare, a governmental fund may invest in real estate.) Governments generally report those other governmental fund investments using cost-based measures, which means that the investments are recorded at original cost when acquired and that any purchased discount or premium from the investment's face or maturity value is accreted or amortized to investment income over the life of the investment in a systematic and rational manner. Investment income also is reported for realized gains and losses if those investments are sold at an amount different from their carrying amount when the sale takes place. However, if there are declines in the fair value of investments reported using cost-based measures, an unrealized loss may have to be recorded if the decline is not due to a temporary condition. For example, a government's liquidity needs may require the sales of investments at losses after the reporting date. That circumstance may represent a permanent decline that should be recognized in the current-period financial statements.

5.22 GASB Statement No. 10, as amended, provides specific cost-based guidance for reporting other investments held by public entity risk pools. Additional guidance is included in the GASB 10 Q&A.

5.23 Other than investments that are within the scope of GASB Statements No. 10, 25, and 31, as amended, the GASB has not addressed the valuation or recognition of investments reported in the proprietary or fiduciary fund categories or in the government-wide financial statements. However, certain private-sector investment standards are category (a) accounting and financial reporting guidance for governments because GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, as amended, provides that proprietary funds and the government-wide financial statements should or may apply certain private-sector standards.⁴ Those private-sector standards include certain pre-November 30, 1989 private-sector pronouncements, such as Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts* (see the GASB 31 Q&A, item 48). They also may include certain post-November 30, 1989 FASB pronouncements, such as portions of FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended; and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, for those enterprise funds (and resulting business-type activities) that apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended.

5.24 Despite the use of different bases of accounting in different financial statements and fund categories, investment income is measured the same way under the accrual and modified accrual bases of accounting. That is, investment income in governmental funds is not modified for the “availability” criterion. Paragraph 57 in the nonauthoritative Basis for Conclusions of GASB Statement No. 31 states that “The Board believes that governmental fund investments—and changes in the fair value of those investments—are appropriately ‘available,’ thus meriting recognition under the modified accrual basis of accounting.”

Financial Statement Presentation

Financial Position Classifications

5.25 Each of a government’s funds, activities, and component units should report its own cash and investments, including its equity position in internal investment pools. The GASB 31 Q&A, item 73, states that equity positions in internal investment pools should be reported as, for example, “equity in cash management pool,” “equity in internal investment pool,” “cash and cash equivalents,” or “investments.” It also sometimes is necessary to classify certain cash and investments as restricted assets to comply with compliance requirements, such as debt covenants. (See the discussion of restricted assets in Chapter 2, “Financial Reporting.”)

5.26 When one fund has overdrawn its share of an internal investment pool, that fund should report an interfund liability to the fund that the government’s management deems to have lent the amount to the overdrawn fund.⁵ The fund deemed to have lent the amount should report an interfund

⁴ See the discussion of the hierarchy of governmental GAAP in Chapter 1 and the discussion of the applicability of certain private-sector standards in Chapter 2, “Financial Reporting.”

⁵ Such overdrawn positions may represent instances of noncompliance if the government has a prohibition against interfund borrowing.

receivable from the borrowing fund. This treatment is unaffected by whether the lending and borrowing funds are of the same or different fund types or categories. However, in the government-wide financial statements, those inter-fund accounts should be eliminated as required for internal balances by GASB Statement No. 34, paragraph 58. (See the discussion of interfund eliminations in Chapter 9, “Interfund, Internal, and Intra-Entity Activity and Balances.”) If a cash account for the government is overdrawn in total, the balance should be classified as a liability in the fund and government-wide financial statements.

5.27 Some governments consider their arbitrage rebate liability to be a revenue-generated liability and adjust interest earnings for the annual change in the liability. Other governments consider the arbitrage rebate liability to be an expense-generated liability and adjust expenses for the annual change in the liability. With the expense-generated approach, expenditure recognition and liability reporting in the governmental funds is subject to the modified accrual basis of accounting.

5.28 Agency funds may have negative cash balances because more cash has been paid out than received. The funds also may have incurred more liabilities than there are assets to pay them. In those cases, the government may have a liability to cover the shortages with amounts from other funds, and should report an interfund receivable in the agency funds.

Activity Classifications

5.29 GASB Statement No. 31, paragraph 13, provides that when the change in the fair value of investments is identified separately as an element of investment income, it should be captioned “net increase (decrease) in the fair value of investments.” For investments reported at fair value, realized gains and losses should not be displayed separately from the net increase (decrease) in the fair value of investments in the financial statements; note disclosure of those realized gains and losses with certain prescribed language is permitted. (Different display standards apply for defined benefit pension plans and governmental external investment pools as discussed below and in Chapter 12, respectively.)

5.30 The GASB 31 Q&A, item 39, indicates that realized gains and losses may be reported for investments that are reported using cost-based measures. If that is done, that Q&A item states that the financial statements should clearly indicate that the presentation applies only to securities reported at amortized cost.

5.31 GASB Statement No. 31, paragraph 14, as amended, states that, often, income from investments associated with one fund is assigned to another fund because of legal or contractual provisions. In that situation, the accounting treatment should be based on the specific language of the legal or contractual provisions. If, however, the investment income is assigned to another fund for other than legal or contractual reasons—for example, management decision—the income should be recognized in the fund that reports the investments. The transfer of that income to the recipient fund should be reported as an interfund transfer.

5.32 GASB Statement No. 34, paragraph 51, provides that earnings on endowments or permanent fund investments should be reported as program revenues in the government-wide statement of activities if the earnings are restricted to one or more programs specifically identified in the endowment or

permanent fund agreement or contract. It also states that investment earnings should be reported as program revenues when legal restrictions require the earnings from the investment of accumulated program resources to be used for that program. If investment earnings do not meet either of those criteria, they should be reported as general revenues. Item 72 of the GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A) discusses how the change in fair value of investments is classified as program or general revenues.

5.33 In proprietary funds, interest income generally is reported as nonoperating revenue. However, it should be classified as operating revenue when it meets the definition of operating revenue that is appropriate to the nature of the activity. For example, footnote 42 to GASB Statement No. 34 states that interest revenue should be reported as operating revenue by a proprietary fund established to provide loans to first-time homeowners. See the further discussion of the classification of operating revenue in Chapter 6, “Revenues and Receivables.”

5.34 As further discussed in Chapter 2, GASB Statement No. 9, as amended, requires a statement of cash flows for all proprietary funds and governments that use proprietary fund accounting. The statement of cash flows should explain the change during the period of all cash and cash equivalents, including restricted cash and cash equivalents. Cash equivalents, which are defined in GASB Statement No. 9, paragraph 9, generally are only those investments with original maturities of three months or less from the date of purchase, although not all investments that meet the GASB’s definition of cash equivalents are required to be treated as such. GASB Statement No. 9, paragraph 8, states that the total amounts of cash and cash equivalents at the beginning and the end of the period in the statement of cash flows should be easily traceable to similarly titled items or subtotals shown in the financial position statements as of those dates. Additional details concerning those requirements are in the GASB 9 Q&A.

Fund Classification—Individual Investment Accounts

5.35 Some governments provide individual investment accounts to other, legally separate entities that are not part of the same financial reporting entity by acquiring specific investments for those other entities. With individual investment accounts, the investments’ income and value changes affect only the entity for which the investments were acquired. GASB Statement No. 31, paragraph 20, states that governments that provide individual investment accounts should report those investments in one or more separate investment trust funds. The financial reporting for investment trust funds is described in the Chapter 12 section on governmental external investment pools.

Disclosures⁶

5.36 GASB pronouncements require numerous disclosures about cash and investments. Among the required disclosures are the following:

⁶ Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in Chapter 3, “The Financial Reporting Entity.” In addition, GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, as amended, requires that certain disclosures provide additional or separate information for separate funds of the primary government (including blended component units), depending on circumstances and significance. See, for example, GASB Statement No. 3, paragraph 70, as amended.

- The types of investments authorized by legal or contractual provisions (GASB Statement No. 3, paragraph 65, as amended)
- Actions taken to address significant violations of legal or contractual provisions, which would include provisions relating to cash and investments (GASB Statement No. 38, paragraph 9)
- The carrying amounts and fair values of investments owned at year-end, by type of investment (GASB Statement No. 3, paragraph 68, as amended)
- The types of investments made during the period but not owned as of the balance-sheet date (GASB Statement No. 3, paragraph 74)
- The accounting methods for investments (GASB Statement No. 31, paragraph 15)
- Certain information about investments in external investment pools (GASB Statement No. 31, paragraph 15)
- The assignment of investment income between funds (GASB Statement No. 31, paragraph 15)
- Custodial credit risk categories for deposits with financial institutions and investment securities (see paragraph 5.37)
- The definition of cash and cash equivalents (GASB Statement No. 9, paragraph 11)
- Details about derivatives and similar investment transactions, including certain information about the indirect use, holding, or writing of derivatives, for example, through participation in a mutual fund or investment pool that holds derivatives (GASB TB 94-1, paragraphs 2 through 5)
- Specific information relating to investment appreciation and income available for spending on donor-restricted endowments (GASB Statement No. 34, paragraph 121)⁷

GASB Statement No. 3, as amended, and GASB TB 94-1 provide nonauthoritative illustrations of some of those disclosures, and the GASB 3 and 31 Q&As provide additional guidance on making the required disclosures. Private-sector standards that apply to the proprietary fund and government-wide financial statements may require additional disclosures.

5.37 The disclosure of custodial credit risk categories for deposits with financial institutions and investment securities is perhaps the most unique of the government-specific disclosures for cash and investments. GASB Statements No. 3 (paragraphs 67 through 70) and No. 28 (paragraph 16), as amended, provide standards for the custodial credit risk disclosure, and GASB TBs No. 87-1 and No. 97-1 and the GASB 3 Q&A provide guidance. The carrying amounts of deposits and, separately, investment securities (by investment type) should be classified into one of three categories of custodial credit risk. The appropriate category depends on—

- Whether the deposit or security is covered by custodial insurance
- Whether an investment security is registered in the government's name
- The extent of segregation between the pledging, sale, or acquisition of securities and their custody, and in whose name the custodian holds the securities

⁷ See the detailed discussion of spending policies on endowments in the college and university section of Chapter 12, "Special-Purpose and State Governments."

GASB Statement No. 3, paragraph 69, states that the custodial credit risk categories may not apply to all types of investments. In general, investments in pools managed by other governments or in mutual funds should not be categorized because they are not evidenced by securities that exist in physical or book entry form. It also states that securities underlying reverse repurchase agreements should not be categorized because they are held by the buyer-lender. GASB Statement No. 28, paragraph 16, states that securities underlying securities lending transactions should not be classified by category of custodial credit risk if the collateral for those loans is reported in the balance sheet.

5.38 Because the note disclosures focus on deposits and investments, whereas the financial statements report cash and cash equivalents and investments, some governments disclose a reconciliation between the amounts in the notes and the amounts in the financial statements. When presenting such a reconciliation to the government-wide statement of net assets, one reconciling item might involve amounts from the fiduciary funds, which may be part of the disclosure but will not be part of the statement of net assets.

Governmental External Investment Pools

5.39 See Chapter 12 for a discussion of the accounting and financial reporting standards for governmental external investment pools, including the standards relating to investments. That chapter also discusses the accounting and financial reporting standards when those pools are included in the financial statements of the sponsoring government.

Defined Benefit Pension Plans

5.40 GASB Statement No. 25, as amended, establishes accounting and financial reporting standards for investments held by defined benefit pension plans. Those investments (except insurance contracts) should be reported at fair value. GASB Statement No. 25, paragraph 24, provides that unallocated insurance contracts may be reported at contract value; allocated insurance contracts should be excluded from plan assets. The guidance in GASB Statement No. 31, as amended, on measuring the fair value of certain investment types also applies to the investments of these plans.

5.41 GASB Statement No. 25, paragraph 29, requires the additions section of the statement of changes in plan net assets to include a separate category that displays net investment income, including (a) the net appreciation (depreciation) in the fair value of plan investments; (b) interest income, dividend income, and other income not included in item a; and (c) total investment expense, separately displayed, including investment management and custodial fees and all other significant investment-related costs. GASB Statement No. 25, paragraph 32, requires certain disclosures about plan investments in addition to those required by other GASB standards and discussed in paragraph 5.36. Additional guidance on defined benefit pension plan investments is in the GASB 25, 26, and 27 Q&A.

Reverse Repurchase Agreements

5.42 GASB Statement No. 3, as amended, includes accounting and financial reporting standards for reverse repurchase agreements. Yield maintenance reverse repurchase agreements, which are defined in GASB Statement No. 3, as amended, are accounted for as sales and purchases of securities. The

assets and liabilities arising from other reverse repurchase agreements are not netted on the financial position statements. Rather, they are separately reported as “investments” and “obligations under reverse repurchase agreements.” Similarly, the interest cost of those other agreements is reported as interest expenses/expenditures and not netted with interest earned on any related investments. GASB Statement No. 3, as amended, also addresses the accounting for reverse repurchase agreements when investing on a pooled basis. It also requires various specific disclosures about the agreements, which are illustrated in the nonauthoritative appendix B of GASB Statement No. 3.

Securities Lending Transactions

5.43 The accounting and financial reporting standards for securities lending transactions are in GASB Statement No. 28, as amended. Governmental entities should report the securities lent as assets. Unless collateralized by letters of credit or by securities that the government does not have the ability to pledge or sell unless the borrower defaults, securities lending transactions are reported as assets and liabilities on the financial position statements. For example, cash received as collateral on securities lending transactions and investments made with that cash should be reported as assets, and the obligation to return that cash should be reported as liabilities. Similarly, the interest cost of those transactions is reported as interest expenses/expenditures and not netted with related interest or other income. GASB Statement No. 28, as amended, also addresses the accounting for securities lending transactions when investing on a pooled basis, requires various specific disclosures about the transactions, and provides nonauthoritative illustrations.

Auditing Considerations

5.44 Statement on Auditing Standards (SAS) No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on planning and performing auditing procedures for financial statement assertions about those items, as defined in certain FASB standards and SAS No. 92.⁸ Among other things, SAS No. 92:

- Indicates that an auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities, such as the ability to identify a derivative that is embedded in a contract or agreement.
- Presents examples of factors that affect inherent and control risk for assertions about derivatives and securities
- Provides examples of audit procedures for derivatives, securities, and hedging activities

Auditors should consider the guidance of SAS No. 92 in their audits of a government's cash, investments, and investment-related transactions.

⁸ Statement on Auditing Standards (SAS) No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, applies to audits of governmental entities even though the definitions it uses in paragraphs 2 through 4 to define its scope come from FASB standards. The AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for applying the provisions of SAS No. 92 in all audits, including audits of governmental entities.

5.45 Because many governmental entities use service organizations to make investment decisions, conduct investment transactions, arrange for custody of investment securities, and maintain investment accounting records, auditors should consider the guidance of SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). Also see the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* for clarification regarding the guidance in SAS No. 70, as amended.

5.46 Chapter 4 discusses the auditor's responsibilities under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), for detecting illegal acts. Many compliance requirements that affect a government's cash, investment, and investment-related transactions may not have a direct and material effect on the determination of financial statement amounts. However, the auditor may become aware of noncompliance that could have a material indirect effect on a government's financial statements—for example, deficient collateral on depository accounts; the use of unauthorized depositories and investment counterparties; the use of unauthorized investment types, especially with regard to derivative and similar investment transactions (including indirect positions through, for example, mutual funds and investment pools); the unauthorized use of reverse repurchase agreements or securities lending transactions; the lack of separate accounts for individual funds when required; or the use of internal investment pools when not authorized or not consistent with the investment objectives for the various involved funds. If the auditor identifies noncompliance that has a material indirect effect on the financial statements, the auditor should consider whether that noncompliance has been properly disclosed in the notes to the entity's financial statements. If the noncompliance has not been properly disclosed, the auditor should consider the effect on the report on the financial statements. The auditor also should communicate the noncompliance to the audit or equivalent committee as provided in SAS No. 54.

5.47 The audit objectives for cash, investments, and investment-related transactions, categorized by financial statement assertion, are as follows:

- **Existence or Occurrence.** The cash, investments, and investment-related transaction balances reported in the financial statements properly represent positions that are on hand, in transit, or in custody and safekeeping by others on behalf of the entity. Investment income reported in the financial statements properly represents earnings on positions held by the entity.
- **Completeness.** The government reports all balances of cash, investments, and investment-related transactions, all related income and expenses/expenditures, and all appropriate cash flow activity.
- **Rights and Obligations.** Conditions or agreements that limit the entity's rights to or obligations concerning cash, investments, and investment-related transactions are properly reflected in the financial statements.
- **Valuation or Allocation.** Cash, investment, and investment-related transaction balances reflect a proper cutoff of cash receipts and disbursements and investment trades and are reported at the proper amounts and in the proper funds. Investment income and expenses/expenditures, including those from internal investment pools, are reported in the proper fund.
- **Presentation and Disclosure.** All balances, income, and expenses/expenditures of cash, investments, and investment-related transactions

are properly classified and adequately disclosed. Financial statement presentation and disclosure are in conformity with generally accepted accounting principles (GAAP) consistently applied.

5.48 In auditing cash, investments, and investment-related transactions, it usually is more efficient and effective to plan to apply procedures based on the manner in which the government manages its portfolios rather than based on the manner in which it accounts for those transactions and balances. However, in applying a portfolio approach to the audit, the auditor needs to determine that adequate procedures are performed related to activity and balances in each of those opinion units with material cash, investments, and investment-related transactions. (See the discussion of opinion units in Chapter 4, “Planning the Audit.”)

5.49 The auditor should obtain an understanding of the government’s internal control over cash, investments, and investment-related transactions. In addition to standard internal control features for those accounts, features that are unique or significant in government may include the following:

- The integration of the entity’s investment program with its cash-flow needs
- Procedures to ensure that written agreements with investment advisers, managers, and external investment pools address all important factors and that they are adhered to
- The periodic review and supervisory approval of accounts for appropriate amounts and types of insurance and collateral
- A process to ensure that appropriate custodial procedures are followed for collateral and investment securities, including that those procedures ensure the entity’s appropriate rights to the securities and that securities are periodically inspected or confirmed with custodians
- The periodic determination of the fair value of investments (including, if deemed necessary, confirmation of those fair values with a second source) and management review of those fair values
- Procedures to review investments that are reported using cost-based measures for impairment losses and to appropriately write down the carrying amounts of those investments
- Procedures for identifying overdrawn cash balances (whether relating to a fund’s position in an internal investment pool or a cash account in total) and for reporting those negative balances as liabilities
- Procedures for identifying fund liabilities for overspent or over-committed agency funds
- Procedures to ensure that an arbitrage rebate liability is accurately calculated (including, if necessary, the use of a specialist to perform the calculation) and policies for reporting the liability in the financial statements on a consistent basis
- The timely and accurate allocation of pooled investment income to individual funds in conformity with compliance requirements and management policy
- Policies and procedures to ensure that classifications and presentations in the statement of cash flows are in conformity with GAAP
- The timely and accurate reporting of transactions and balances to individuals or other governments for whom investment positions are held

- Procedures to compare actual investment earnings to budgeted amounts and to investigate significant variances
- Policies and procedures for making all appropriate GAAP-required disclosures in the financial statements

5.50 In addition to standard audit procedures for cash, investments, and investment-related transactions, procedures that are unique or significant in government may include the following:

- Reviewing state and local laws and regulations; debt issuance documents; contribution and grant contracts; and other similar documents for compliance requirements that could have a direct and material effect on the determination of financial statement amounts and determining whether those provisions are appropriately considered in the entity's written investment policy
- Reviewing minutes of meetings of the governing body for authorization of its investment policy and changes to it
- Reviewing the entity's compliance at year-end and during the year with compliance requirements that could have a direct and material effect on the determination of financial statements amounts
- Determining whether the custodial procedures surrounding collateral and investment securities are adequate to secure the entity's rights in the recorded positions
- Reviewing supporting information for the entity's classification of deposits and investment securities in categories of custodial credit risk, including comparing current-year classifications with prior-year classifications, confirming custodial information with the collateral and investment securities custodians, and inquiring about or confirming the nature of relationships between the securities custodians and the investment counterparties
- Noting instances during the year in which the entity's uncollateralized deposits and uninsured, unregistered investment securities held by the counterparty, or by its trust department or agent but not in the entity's name, significantly exceeded that category of custodial credit risk as of year-end
- Determining the entity's policies for valuing its investments and whether those policies are in conformity with GAAP and appropriately applied to the entity's investments
- Evaluating support for the entity's valuation of its investments and its consideration of the need to record impairment losses on investments reported using cost-based measures (Paragraphs 47 through 48 of SAS No. 92 [AICPA, *Professional Standards*, vol. 1, AU sec. 332.47 and .48] include guidance for auditors when evaluating whether management has considered relevant information in determining whether an other-than-temporary impairment condition exists.)
- Determining whether overdrawn cash balances are properly reported as liabilities rather than as negative cash balances
- Determining whether interfund balances are properly recorded for overspent or over-committed agency funds
- Evaluating whether the arbitrage rebate liability is accurately calculated (including confirming appropriate information with bond counsel and using a specialist if necessary) and whether the liability is properly presented in the financial statements

- Reviewing that the allocation of internal investment pool balances, income, and expenses/expenditures is reasonable, accurate, in conformity with GAAP, and properly classified and disclosed in the financial statements
- Evaluating that, in presenting its statement of cash flows, the entity uses the direct method, properly reports cash flows as gross or net, properly classifies cash receipts and payments, reconciles operating income to net cash flow from operating activities, and discloses non-cash investing and financing activities
- Confirming with individuals and other governments for whom the entity performs investment services that they have received timely and accurate reporting of transactions and balances
- Investigating significant variances between budgeted and actual investment earnings
- Determining whether the entity's cash, investment, and investment-related transaction disclosures (including disclosures of restricted investments) conform to GAAP
- Reconciling the deposit and investment amounts disclosed in the notes to the financial statements to the cash and cash equivalent and investment amounts presented in the financial statements

Chapter 6

Revenues and Receivables

Introduction

6.01 Revenue¹ and receivable transactions are closely related, and many audit procedures satisfy the audit objectives of both types of accounts at the same time. That is, evidence that supports assertions about revenues also generally supports assertions about receivables. This chapter discusses accounting, financial reporting, and auditing considerations relating to various transactions and events that result in revenues and receivables.

Nature of Transactions

6.02 In government, there often are numerous locations for billing, accounting, and cash collection—for example, tax collection departments for income, sales, or property taxes; billing departments for services rendered; courts for fines or judgments; and recreational facilities and parking garages for user fees. Because billing, accounting, and collection functions may not be centralized, an entity's need to establish multiple internal control systems related to those functions may increase control risk over revenues and receivables. Also, cash collections of small, occasional receipts, such as for permits and licenses, may increase control risk.² Sometimes a government's revenues are collected by another entity, either another government (such as a county tax collector or a tax bureau) or a nongovernmental entity (such as a financial institution with which the government contracts for “lock-box” services).

6.03 General-purpose governments typically have large amounts of revenues and receivables that result from nonexchange transactions, particularly in governmental funds and activities. As defined in Governmental Accounting Standards Board (GASB) Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, paragraph 1, in a nonexchange transaction, a government gives (or receives) value without directly receiving (or giving) equal value in exchange. Examples of nonexchange revenues are those that arise from income, sales, and property taxes; fines and certain fees; certain intergovernmental grants, entitlements, and other financial assistance; and private donations.

6.04 Governments also have revenues and receivables that result from exchange and exchange-like transactions, particularly in proprietary funds and business-type activities. As defined in GASB Statement No. 33, paragraph 1, exchange and exchange-like transactions are those in which each party receives

¹ In general, this chapter does not discuss interfund transfers, loans, or reimbursements; see Chapter 9, “Interfund, Internal, and Intra-Entity Activity and Balances,” for those items. The term *revenue* is used in a generic manner throughout much of this chapter to refer to the resource inflows from other than interfund transfers that are reported in a government's activity statements. GASB standards require different classifications of those reported resource inflows in the various financial statements, as discussed later in this chapter.

² Even small amounts of cash collections may be of concern to an auditor because of the entity's fiduciary responsibilities for the moneys and the adverse publicity that can result from a loss.

and gives up essentially equal values.³ Examples of exchange and exchange-like revenues are those that arise from investment income; user fees; and sales and leases of capital assets.

6.05 Activities between the funds of a primary government and between a primary government and its component units also may generate revenues and receivables. For example, the general fund or internal service funds may provide services to other funds—for example, communications (telephone and mail), data processing, printing and duplication, motor pool and maintenance operations, central supplies, building occupancy and maintenance, and risk retention. Chapter 9, “Interfund, Internal, and Intra-Entity Activity and Balances” discusses accounting, financial reporting and auditing considerations for reporting those activities in the financial reporting entity’s financial statements. However, the measurement and recognition standards for some of the transactions and other events discussed in or referenced from this chapter apply to those activities, subject to the provisions concerning interfund, internal, and intra-entity activity and balances of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*. Although the provisions of GASB Statement No. 33, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, which are discussed in this chapter, do not apply to activities between the funds of a primary government, they do apply to the recognition and measurement of transactions between the primary government and its component units. However, the provisions of GASB Statement No. 34 for interfund, internal, and intra-entity activity and balances affect how nonexchange transactions between the primary government and its component units are reported when component units are included with the primary government in the reporting entity’s financial statements.

6.06 The revenue transactions of governments, particularly nonexchange transactions, often are subject to various compliance requirements, such as the following:

- Many intergovernmental grants and entitlements and private donations have eligibility requirements, purpose restrictions, and other requirements that the government should meet to comply with the terms of the grant or gift.
- Legal provisions often establish various limits on the government’s taxation of its citizens. Property tax levies often are subject to a budgetary process that requires public notification and hearings and the passage of appropriations that limit the government’s spending authority.
- Sometimes, governments are required to obtain voter approval to issue debt and levy property taxes to repay that debt.
- Specific voter approval often is required before a local government can impose or increase its sales or income tax rates, and those approvals often are subject to purpose restrictions on the use of the incremental revenues.
- Some governments have legal provisions that limit their revenues or their revenue growth, including limits on specific types of taxes, such as millage rate maximums on property taxes. Exceeding those limits may trigger a legal provision for tax refunds.

³ Footnote 1 of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, states that “In contrast to a ‘pure’ exchange transaction, an exchange-like transaction is one in which the values exchanged, though related, may not be quite equal or in which the direct benefits may not be exclusively for the parties to the transaction. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting recognition.”

- Special assessments collected from a particular group of property owners should be used to finance capital improvements or services to those property owners.
- Many governments are permitted to seize or sell property for nonpayment of taxes, but there are legal provisions relating to the due process procedures they should follow to do so.

Although a government should be concerned with all compliance requirements, generally accepted auditing standards (GAAS) focus the auditor's concern on compliance requirements that could have a direct and material effect on the determination of financial statement amounts. (See the further discussion of the auditor's responsibility in that regard in Chapter 4, "Planning the Audit.")

6.07 Like other entities, governments have revenue collectibility concerns. In government, legal provisions often are designed to improve the collectibility of certain revenues, particularly tax revenues. For example, real property taxes often are deemed to be fully collectible because of legal provisions that permit the government to place a delinquent-tax lien against the property. Further, some governments that levy income taxes have legal provisions that allow them to apply overpayments that otherwise would be refunded to taxpayers against unpaid receivables for the same type of taxes, other types of taxes, or other amounts, such as utility service charges. However, for those legal provisions to be effective in reducing uncollectible receivables, the government has to enforce its legal rights. For example, a government that does not file liens against properties with delinquent tax payments generally would be unable to seize or sell that property to collect the delinquent revenue.

6.08 Amounts resulting from revenue transactions are classified in governmental financial statements in various ways. In the government-wide statement of activities, such amounts are classified as program revenues, general revenues, contributions to term and permanent endowments, contributions to permanent fund principal, special items, and extraordinary items. The governmental and proprietary fund financial statements report revenues by major source and distinguish special items and extraordinary items from other revenues. Also, governmental funds distinguish revenues from other financing sources. Proprietary funds separately distinguish operating revenues and nonoperating revenues from capital contributions and additions to term and permanent endowments. The fiduciary fund statement of changes in net assets classifies transactions as "additions" rather than as "revenues." In governmental financial statements, no resource inflows are reported as direct changes in equity. See the detailed discussions of the classification of resource inflows in a government's financial statements in paragraphs 6.61 through 6.76.

Accounting and Financial Reporting Considerations

6.09 This section on accounting and financial reporting considerations is structured to discuss the following:

- General recognition standards
- Recognition standards for (a) nonexchange transactions, (b) exchange transactions, (c) special assessments, and (d) amounts collected for individuals, other entities, or other funds
- Financial statement presentation for revenues and receivables
- Disclosures in the notes to the financial statements

Accounting

General Recognition Standards

6.10 Revenue recognition is affected by a financial statement's measurement focus and basis of accounting (MFBA). The government-wide statement of activities; the proprietary funds statement of revenues, expenses, and changes in net assets (or fund equity); and the fiduciary funds statement of changes in fiduciary net assets use the economic resources/accrual MFBA. Because of the economic resources measurement focus, revenue is reported for transactions and events involving not only the receipt of cash but also the receipt of capital assets (that is, capital asset donations). Because of the accrual basis of accounting, revenues and receivables resulting from exchange and exchange-like transactions are recognized in those financial statements when the exchange takes place;⁴ revenues and receivables from nonexchange transactions are recognized in conformity with GASB Statement No. 33, as amended, as explained in detail later in this chapter.

6.11 The governmental funds statement of revenues, expenditures, and changes in fund balances uses the current financial resources/modified accrual MFBA.⁵ Because of the current financial resources measurement focus, governmental funds are not required to report revenues for donations of capital assets.⁶ National Council on Government Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 62, establishes the standard for the modified-accrual recognition of revenues and other financial resource increments in governmental funds. It states that revenues should be recognized in the accounting period in which they become both measurable and available. *Measurable* refers to the ability to quantify in monetary terms the amount of the revenue and receivable. The term *available* generally means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period.

6.12 The only difference between accrual-basis recognition of financial resource inflows and modified accrual-basis recognition of financial resource inflows relates to availability.⁷ The GASB has not established specific standards that define how to apply the availability criterion, except for property tax revenues as discussed in paragraph 6.30. However, many governments use the property tax standard by analogy and accrue other revenues in governmental

⁴ For accrual-based recognition purposes, revenue from exchange and nonexchange transactions should be measurable. See GASB Statement No. 33, paragraph 11 and, in the nonauthoritative Basis for Conclusions, paragraph 56.

⁵ Although transactions and other events associated with the governmental funds are reported in the fund financial statements using the current financial resources/modified accrual measurement focus and basis of accounting (MFBA), they are reported in the government-wide financial statements using the economic resources/accrual MFBA, usually as governmental activities. That "conversion" from one MFBA to another is explained through the presentation in the governmental fund financial statements of a summary reconciliation to governmental activities in the government-wide financial statements. See the further discussion of those reconciliations in Chapter 10, "Equity and Financial Statement Reconciliations."

⁶ The GASB staff document, *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A), item 170, states that, in governmental funds, donated capital assets that are held for use are not recorded in the fund as an asset or revenue. GASB standards do not address the accounting for donated capital assets that are not held for use.

⁷ There are other differences between resource inflow recognition in the governmental funds and that in a government's other financial statements (such as in the government-wide financial statements), but those differences arise from the differences in measurement focus, rather than from differences in basis of accounting. That is, a measurement focus on economic resources recognizes different transactions than does a measurement focus on current financial resources.

funds based on the amount of the year-end receivables received in cash during a given number of days after year end. Many governments apply this “time period approach” consistently for all types of revenues and in all governmental funds and apply it consistently from year to year.

6.13 With the modified accrual basis of accounting, revenues resulting from exchange and exchange-like transactions are recognized when the exchange takes place, subject to the measurable and available criteria. Revenues from nonexchange transactions are recognized in accordance with GASB Statement No. 33, as amended, again, subject to the measurable and available criteria. Receivable balances in the governmental funds are reported using the accrual basis of accounting. Differences between the amounts reported as receivables and the amounts recognized as revenues are reported as deferred revenues (a liability).

6.14 All receivables should be measured net of estimated uncollectible amounts. Charges for uncollectible revenues should reduce revenues, deferred revenues, or the allowance for uncollectible revenues, as applicable; charges for uncollectible revenues should not be reported as expenses. (These requirements for reporting charges for uncollectible revenues are explained in GASB Statement No. 34, footnote 41, GASB Statement No. 33, paragraphs 16 and 18, and the GASB staff document, *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Questions and Answers* [GASB 34 Q&A], item 138.) (See also item 153 of the GASB staff document, *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* [2nd GASB 34 Q&A] for a discussion of the accounting for uncollectible nonexchange revenues.)

6.15 The remainder of this section on the accounting for revenues primarily discusses how to recognize various types of revenues using the economic resources measurement focus and accrual basis of accounting. In the governmental funds, the accrual-based recognition of revenue generally should be modified for the availability criterion as discussed in paragraphs 6.11 and 6.12. The remainder of this section also discusses some specific accounting and financial reporting requirements in governmental funds that go beyond the general recognition standards for those funds.

Nonexchange Transactions

6.16 GASB Statement No. 33, as amended, establishes accounting and financial reporting standards for nonexchange transactions. It identifies four classes of nonexchange transactions based on shared characteristics that affect the timing of recognition:

- a. *Derived tax revenues.* These result from assessments imposed on exchange transactions (for example, income taxes, sales taxes, and other assessments on earnings or consumption).
- b. *Imposed nonexchange revenues.* These result from assessments imposed on nongovernmental entities, including individuals, other than assessments on exchange transactions (for example, property taxes and fines).
- c. *Government-mandated nonexchange transactions.* These occur when a government at one level provides resources to a government at another level and requires the recipient to use the resources for a specific purpose (for example, federal programs that state or local governments are mandated to perform).

- d. *Voluntary nonexchange transactions.* These result from legislative or contractual agreements, other than exchanges, entered into willingly by the parties to the agreement (for example, certain grants and private donations).

6.17 GASB Statement No. 33, paragraph 11, requires recognition of non-exchange transactions unless the transactions are not measurable or are not probable of collection. (GASB Statement No. 33 states that *measurable* means reasonably estimable and that *probable* means the future event(s) are likely to occur.) Table 6.1 presents the asset and revenue recognition requirements for nonexchange transactions; resources received or reported as receivables before revenue is recognized are reported as deferred revenues. Additional details about the general recognition standards for nonexchange transactions are provided in paragraphs 6.18 through 6.23. Table 6.1 provides references to the paragraphs in this chapter in which the recognition for particular transactions types are discussed.

Table 6.1

Asset and Revenue Recognition: Nonexchange Transaction Reporting

<i>Class of Nonexchange Transaction</i>	<i>Asset Recognition— Both Accrual and Modified Accrual Bases of Accounting</i>		<i>Revenue Recognition^{a,b}</i>	
			<i>Accrual Basis of Accounting</i>	<i>Modified Accrual Basis of Accounting</i>
Derived tax revenues, ^c which generally include income and sales taxes and similar assessments on earnings or consumption (paragraphs 6.24 through 6.27)	<ul style="list-style-type: none"> • Receivables when underlying exchange transaction occurs or cash when the resources are received, whichever is first 		<ul style="list-style-type: none"> • When the underlying exchange occurs 	<ul style="list-style-type: none"> • When the underlying exchange occurs, subject to “availability” criterion
Imposed nonexchange revenues, which generally include property taxes (paragraphs 6.28 through 6.30), fines (see paragraph 6.39), and certain fees (paragraphs 6.40 and 6.41)	<ul style="list-style-type: none"> • Receivables when the government has an enforceable legal claim to the resources or cash when the resources are received, whichever is first^d 		<ul style="list-style-type: none"> • When use of the resources is required or first permitted by time requirements^e in enabling legislation, or at the same time as the assets if there are no time requirements 	<ul style="list-style-type: none"> • When use of the resources is required or first permitted by time requirements^e in enabling legislation, or at the same time as the assets if there are no time requirements, subject to “availability” criterion
Government-mandated and voluntary nonexchange transactions, ^f which generally include most intergovernmental revenues (paragraphs 6.31 through 6.34) and certain private donations and promises (pledges) of future donations (paragraph 6.36 through 6.38), including endowments (paragraph 6.35)	<ul style="list-style-type: none"> • Receivables when all applicable eligibility requirements^g are met or cash when the resources are received, whichever is first • Promises from nongovernmental entities also should be verifiable 		<ul style="list-style-type: none"> • When all applicable eligibility requirements^g are met (For endowments, time requirements are met when resources are received. See paragraph 6.35.) 	<ul style="list-style-type: none"> • When all applicable eligibility requirements^g met, subject to “availability” criterion (For endowments, time requirements are met when resources are received. See paragraph 6.35.)

^a Purpose restrictions, which specify the purpose for which resources should be used, do not affect when revenue from a nonexchange transaction is recognized. Instead, they affect the reporting of equity. See paragraph 6.18.

^b Deferred revenues should be reported for assets recognized before revenue is recognized.

^c If derived tax revenues have time requirements, asset and revenue recognition should be consistent with the requirements for imposed nonexchange revenue transactions.

^d Paragraph 17 of GASB Statement No. 33 provides that for some governments, the enforceable legal claim to property taxes does not arise until the period after the period for which the taxes are levied. Those governments should recognize property taxes receivable in the same period that revenues are recognized.

^e See paragraph 6.18 for a definition of time requirements. Note also the presumption of time requirements for nonexchange transactions between government discussed in paragraph 6.20.

^f The recognition standards for government-mandated and voluntary nonexchange transactions are the same despite the involuntary versus voluntary characteristics of the transactions.

^g See paragraph 6.19 for a listing of eligibility requirements.

6.18 GASB Statement No. 33 distinguishes between two kinds of stipulations on the use of resources: time requirements and purpose restrictions. Time requirements specify the period (or periods) when resources are required to be used or when use may begin, or require that the resources be maintained intact as specified by the provider. Time requirements affect the timing of recognition of nonexchange transactions. Purpose restrictions specify the purpose for which the resources should be used. Purpose restrictions do not affect when revenue from a nonexchange transaction is recognized; instead, they affect the reporting of equity. (See Chapter 10, “Equity and Financial Statement Reconciliations.”)

6.19 For government-mandated and voluntary nonexchange transactions, the provider may establish eligibility requirements that affect the recognition of revenue. The four types of eligibility requirements are as follows:

- a. *Required characteristics of recipients.* The provider specifies certain characteristics for the recipient or secondary recipient. For example, under a certain federal program, recipients are required to be states and secondary recipients are required to be counties.
- b. *Time requirements.* See the definition in paragraph 6.18.
- c. *Reimbursements.* The provider offers resources on a reimbursement (“expenditure-driven”) basis and the recipient has incurred allowable costs under the applicable program.
- d. *Contingencies (applies only to voluntary nonexchange transactions).* The provider offers resources contingent upon a specified action of the recipient, and that action has occurred. For example, the recipient is required to raise a specific amount of resources from third parties or to dedicate its own resources for a specified purpose and has complied with those requirements.

6.20 Sometimes a provider in a government-mandated or voluntary nonexchange transaction does not specify time requirements. If the provider is *not* a government, no time requirement is presumed, and the entire award should be recognized in the period when all of the applicable eligibility requirements are met (applicable period). Conversely, if the provider is a government (including the federal government), GASB Statement No. 33 presumes a time requirement if one is not specified. The entire award should be recognized in the period when all applicable eligibility requirements are met (applicable period). The presumed applicable period is the immediate provider’s fiscal year and begins on the first day of that year. (The GASB chose the first day of the immediate provider’s fiscal year because it is the effective date of that government’s appropriation to disburse the resources.) If a provider government has a biennial budgetary process, each year of the biennium should be considered a separate applicable period, and the recipients should allocate one-half of the resources appropriated for the biennium to each applicable period, unless the provider specifies a different allocation. The following example is provided in the nonauthoritative Basis for Conclusions of GASB Statement No. 33—if a federal grant that a state passes through to counties does not specify a time requirement, the applicable period for state revenue recognition purposes begins on the first day of the federal fiscal year and the applicable period for county revenue recognition purposes begins on the first day of the state fiscal year.

6.21 Promises from nongovernmental entities to provide cash or other assets are sometimes referred to as *pledges*, *promises to give*, or *promised donations*. Recipients of those promises should recognize revenues and receivables

when all eligibility requirements are met, provided that the promise is verifiable and the resources are measurable and probable of collection.

6.22 Paragraph 26 of GASB Statement No. 33 provides guidance on the contravention of provider stipulations. After a nonexchange transaction has been recognized in the financial statements, it may become apparent that (a) the eligibility requirements are no longer met or (b) the recipient will not comply with the purpose restrictions within the specified time limit. In these circumstances, if it is probable that the provider will not provide the resources or will require the recipient to return all or part of the resources already received, the recipient should recognize a decrease in assets (or an increase in liabilities) and an expense for the amount that the provider is expected to cancel or reclaim. These contraventions of provider stipulations differ from the uncollectible receivables discussed in paragraph 6.14 and thus are not reported as revenue reductions. (Chapter 8, “Expenses/Expenditures and Liabilities,” discusses the GASB standards for recognizing expenditures and liabilities in governmental funds.)

6.23 GASB Statements No. 33 and No. 36 illustrate the application of their standards to various nonexchange transactions in nonauthoritative appendixes. The 2nd GASB 34 Q&A discusses various issues relating to nonexchange transactions.

Income, Sales, and Similar Taxes

6.24 Income taxes, sales taxes, and other assessments on earnings or consumption generally meet the definition of derived tax revenues. Consequently, under the accrual basis of accounting, revenues are recognized when the underlying exchange transaction occurs, for example, when a retail sale is made or when a taxpayer earns taxable income. Receivables for uncollected revenues are reported when revenue is recognized. Tax payments received before revenue can be recognized are reported as deferred revenues or as part of a tax refund amount. (See paragraph 6.26.)

6.25 The nonauthoritative appendix of illustrative examples in GASB Statement No. 33 indicates that, from a practical standpoint, a government will likely base the amount to be recognized as sales or other consumption tax revenues on total taxable activities reported or estimated for the weeks or quarters that make up the government’s fiscal year. That appendix further indicates that, from a practical standpoint, a government will likely base the amount to be recognized as income tax revenue on the amount of withholding and estimated tax payments made during the government’s fiscal year, adjusted for post-fiscal-year final settlements (additional payments and refunds). Those “practical” explanations do not change the standard for the recognition of those revenues but, rather, recognize the application of materiality considerations. A government that recognizes those revenues following the “practical” approaches has to be able to demonstrate that the effects do not materially misstate the revenue that would be recognized using the “underlying event” standard (for example, because of a high number of unusual transactions).

6.26 Because of the timing of a government’s fiscal year in relation to the taxpayers’ income tax year, many governments will have to estimate the final settlement amounts for additional payments and refunds. GASB standards provide no specific guidance for making those measurements. GASB standards also do not address whether the estimated amount of taxes to be refunded should be reported as liabilities or, instead, as a reduction of related receivables.

6.27 For income, sales, and similar taxes reported in governmental funds, the estimated amount of any taxes to be refunded should be reported in the funds (either as liabilities or as a reduction of related receivables as discussed in paragraph 6.26). Those amounts are reported in the governmental funds (even though they may not be payable in the short term) because they arise from reducing revenue as provided for in GASB Statement No. 33, paragraph 16, or from reducing deferred revenues.

Property Taxes

6.28 Property taxes, which are addressed in NCGA Statement 1, as amended and interpreted by NCGA Interpretation 3, *Revenue Recognition—Property Taxes*, GASB Statement No. 33, and GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds*, generally meet the definition of imposed nonexchange revenues. Consequently, under the accrual basis of accounting, governments should recognize property tax revenues in the period for which the taxes are levied, which often can be determined through the budgetary process. (That is, property tax levies often are made to finance a particular fiscal period.)

6.29 Property tax receivables should be reported the earlier of (a) when revenue is recognized as discussed in paragraph 6.28 and (b) when the enforceable legal claim to the taxes arises, which generally is specified in enabling legislation. Many governments refer to the date the enforceable legal claim arises as the *lien date* (even though a lien is not formally placed on the property at that date) while other governments use a different term, such as the *assessment date*. Property tax payments received before revenues are recognized are reported as deferred revenues.

6.30 To modify property tax revenue recognition in governmental funds for the availability criterion, NCGA Statement 1, as amended and interpreted, stipulates that *available* means “collected within the current period or expected to be collected soon enough thereafter to be used to pay liabilities of the current period.” However, the time after the current period should not exceed sixty days unless there are unusual circumstances that justify a longer period, and those circumstances are disclosed as discussed in paragraph 6.79.

Intergovernmental Revenues

6.31 Intergovernmental revenues, such as grants, entitlements, shared revenues, and appropriations from a primary government to a component unit, generally meet the definition of either government-mandated or voluntary nonexchange transactions. (Some intergovernmental revenues may arise from exchange or exchange-like transactions. For example, a county may house state inmates in its correctional facility for a charge that essentially equals the value the state receives from the service.) Although most intergovernmental revenues involve the receipt of cash for operating purposes, some involve the receipt of capital assets⁸ or cash for capital purposes. The following recognition standards apply to the accrual-based recognition of intergovernmental revenues from government-mandated and voluntary nonexchange transactions, regardless of the nature or purpose of the resources, except for resources received as endowments and similar transactions as discussed in paragraph 6.35.

⁸ As discussed in paragraph 6.11 and footnote 6, governmental funds are not required to report revenues for donations of capital assets.

6.32 Under the accrual basis of accounting, governments should recognize intergovernmental revenue from government-mandated and voluntary nonexchange transactions when all applicable eligibility requirements—required characteristics of recipient, time requirements, reimbursements, and contingencies (for voluntary nonexchange transactions)—are met. (See paragraph 6.20 concerning the presumption of a time requirement if a governmental provider does not specify a time requirement.) Receivables are reported at the same time as revenue unless the payment already has been received. Items 164 and 165 in the 2nd GASB 34 Q&A discuss the effect of the provider government's appropriation process on the recognition of grant revenue.

6.33 GASB Statement No. 36 applies the revenue recognition requirements discussed in paragraph 6.32 to shared revenues regardless of whether the provider government's financing source for those amounts is derived tax revenues or imposed nonexchange revenues. Some shared revenues require an annual appropriation before they can be disbursed. In those situations, as discussed in paragraph 6.20, the entire award should be recognized in the period that begins on the first day of the provider government's fiscal year, provided that all other applicable eligibility requirements are met. Other shared revenues do not require an annual appropriation but instead are disbursed because of continuing appropriations. (Continuing appropriations are appropriations that, once established, are automatically renewed without further legislative action, period after period, until altered or revoked.) The nonauthoritative appendixes of GASB Statement No. 36 explain that when a provider government shares resources under a continuing appropriation, the time eligibility requirement is continuously (automatically) met. Therefore, those nonauthoritative appendixes explain, shared revenues that are remitted to recipients under continuing appropriations should be recognized as the event underlying the shared revenue source occurs (for example, shared sales taxes are recognized as sales occur), subject to any other applicable eligibility requirements. GASB Statement No. 36 states that in measuring the amount of shared revenues disbursed through continuing appropriations, the recipients may rely on periodic notification by the provider government of the accrual-basis information necessary for compliance. If notification by the provider government is not available in a timely manner, recipient governments should use a reasonable estimate of the amount to be accrued.

6.34 As discussed in paragraph 6.22, GASB Statement 33, paragraph 26, provides guidance on recognizing a decrease in assets or an increase in liabilities if, in the period after a nonexchange transaction has been recognized, it becomes apparent that eligibility requirements are no longer met or purpose restrictions will not be met. In addition, if intergovernmental grant revenues are subject to adjustment as, for example, when questioned costs from other than not meeting eligibility requirements or purpose restrictions are identified during a grant compliance audit, the government should consider whether a loss contingency exists. If that is the case, the government should consider whether a liability (or a decrease in receivables) should be recorded or whether disclosure (for example, of a material violation of a finance-related legal or contractual provision) is required.

Endowments and Similar Transactions

6.35 In some government-mandated and voluntary nonexchange transactions, a provider transmits cash or other assets with the stipulation (time requirement) that the resources cannot be sold, disbursed, or consumed until after a specified number of years have passed or a specific event has occurred,

if ever. In the interim, the provider requires or permits the recipient to benefit from the resources—for example, by investing or exhibiting them. Examples of such transactions include permanently nonexpendable additions to endowments and other trusts; term endowments; and contributions of works of art, historical treasures, and similar assets. Under the accrual basis of accounting, GASB Statement No. 33, paragraph 22, and GASB Statement No. 34, paragraph 28, require revenues for these transactions to be recognized when the resources are received, provided that all eligibility requirements have been met.⁹ For these transactions, the time requirement is met as soon as the recipient begins to honor the provider's stipulation not to sell, disburse, or consume the resources and continues to be met for as long as the recipient honors that stipulation. (If such works of art, historical treasures, or similar assets are not capitalized using the guidance of GASB Statement No. 34, paragraph 27, governments should recognize an expense equal to the amount of revenue recognized.)

Donations and Promises of Future Donations From Nongovernmental Entities

6.36 Donations of cash or other assets from nongovernmental entities, including individuals, are private donations. Private donations generally meet the definition of voluntary nonexchange transactions. (Some private donations may arise from exchange or exchange-like transactions. For example, a donor may give a state university a research grant in return for patent rights to the research results, which may be an exchange of essentially equal value.) Private donations may be received with or without purpose restrictions or eligibility requirements and may be received as promises of future donations.

6.37 Under the accrual basis of accounting, governments should recognize receivables and revenues from private donations that are voluntary nonexchange transactions when all applicable eligibility requirements—required characteristics of recipient, time requirements, reimbursements, and contingencies—are met. Amounts received before the revenue recognition requirements are met should be reported as deferred revenues.

6.38 Under the accrual basis of accounting, promises of future donations from nongovernmental entities should be recognized as revenues and receivables when all eligibility requirements are met, provided that the promise is verifiable and the resources are measurable and probable of collection. (Item 167 of the 2nd GASB 34 Q&A, indicates that long-term receivables for nonexchange revenues may be measured using either discounted present values or future values.) However, promises of cash or other assets for endowments and similar transactions (as discussed in paragraph 6.35) should not be recognized as receivables or as revenues before the assets are received.

Fines

6.39 Fines, for example, for violations of traffic or environmental laws, generally meet the definition of imposed nonexchange revenues. Consequently, under the accrual basis of accounting, receivables for fines should be recognized when the government has an enforceable legal claim to the resources. (See the discussion of the recognition of fines in item 158 of the 2nd GASB 34 Q&A.) Revenues should be recognized at the same time as the assets (amounts received or receivables) or, if there are time requirements, in the period the

⁹ See footnote 8.

use of the resources is required or first permitted by those time requirements. Fines that are received or receivable before revenue is recognized should be reported as deferred revenues.

Nonexchange Fees

6.40 GASB Statement No. 33, paragraph 10, indicates that some nonexchange revenues may be termed “fees” or “charges”—terms normally used for exchange and exchange-like transactions. Fees that arise from nonexchange transactions generally meet the definition of imposed nonexchange revenues. Consequently, under the accrual basis of accounting, receivables for nonexchange fees should be recognized when the government has an enforceable legal claim to the resources. Revenues should be recognized at the same time as the assets (amounts received or receivables) or in the period the use of the resources is required or, if there are time requirements, first permitted by those time requirements. Such fees received or receivable before revenue is recognized should be reported as deferred revenues.

6.41 The GASB-established definitions of exchange and exchange-like transactions, the guidance provided in item 150 of the 2nd GASB 34 Q&A,¹⁰ and professional judgment, depending on the facts and circumstances surrounding the transactions, affect the determination of whether particular fees arise in whole or in part from nonexchange transactions or, instead, exchange or exchange-like transactions. To ensure intra- and inter-period consistency in recognizing the revenue from particular fees as nonexchange or, instead, as exchange and exchange-like transactions, governments usually establish policies or practices concerning such determinations. However, the determination may make little practical difference in the absence of time requirements for the use of the fee resources. When there are no time requirements, imposed nonexchange revenues generally are recognized at essentially the same time as exchange transaction revenues (that is, when the government has an enforceable legal claim to the resources versus when earned). (See also the section on user fees starting at paragraph 6.47.)

Pass-Through Grants

6.42 Governmental entities often receive pass-through grants—grants and other financial assistance to transfer to or spend on behalf of a secondary recipient. All cash pass-through grants received by a government should be reported in its financial statements. As a general rule, cash pass-through grants should be recognized as revenue (using the provisions of GASB Statement No. 33, as amended) and expenses/expenditures in a governmental, proprietary, or trust fund. In those infrequent cases in which a recipient government serves only as a cash conduit as defined in GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, paragraph 5, the pass-through grant should be reported in an agency fund.

On-Behalf Payments for Fringe Benefits and Salaries

6.43 GASB Statement No. 24 provides standards for recognizing the effect of on-behalf payments for fringe benefits and salaries, which are direct payments made by one entity (the paying entity or paying government) to a third-party recipient for the employees of another, legally separate entity (the

¹⁰ See footnote 11.

employer entity or employer government). For example, a state government may make contributions directly to a pension plan for elementary and secondary schoolteachers employed in public school districts within the state. GASB Statement No. 24, paragraph 8, requires the employer government to recognize revenue and expenses/expenditures for on-behalf payments for fringe benefits and salaries. The amount the employer government should recognize as revenue should equal the amounts that third-party recipients of the payments received and that are receivable at year-end for the current fiscal year. The amount the employer government should recognize as expenses/expenditures depends on whether the employer government is legally responsible for the payment. See the additional requirements concerning the employer government accounting for such on-behalf payments in GASB Statement No. 24. (Chapter 8 discusses the accounting and financial reporting for such on-behalf payments by the paying government.)

Contributed Services

6.44 Governments often benefit from various “contributed services.” For example, a small city without a police force may receive law enforcement coverage from the state police, a state court may receive office space from county governments, or a county library may use volunteers to supplement its staff. Those services may be provided at no cost, or at a cost that is lower than its value. Sometimes, contributed services arise from “on-behalf payments”—that is, one entity may pay a third-party recipient to provide services to the government. For example, a third party may pay telephone companies to provide free Internet access to school districts. The GASB has not established standards that require a government to recognize revenue (or expenses/expenditures) in its financial statements for contributed services (GASB Statement No. 33 specifically excludes contributed services from its scope). Neither has the GASB prohibited such recognition (although GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, prohibits enterprise funds from applying the guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, which does address the recognition of revenue for contributed services).

Exchange Transactions

6.45 Under the accrual basis of accounting, revenues that result from exchange and exchange-like transactions are recognized when the exchange takes place.

Investment Earnings

6.46 Chapter 5, “Cash, Investments, and Investment-related Activity,” discusses the accounting, financial reporting, and auditing considerations for investment earnings.

User Fees

6.47 Governments have fees that result from exchange and exchange-like transactions. Such fees are referred to as *user fees* and may include amounts charged for the use of various services, such as:

- Public utilities (for example, water, sewer, gas, electric, storm water, and trash disposal)

- Recreation and cultural operations (for example, sports facilities, convention centers, swimming pools, golf courses, and amusement parks)
- Public facilities (for example, parking garages, toll roads and bridges, airports, and docks)

6.48 As discussed in paragraph 6.41, the GASB-established definitions of exchange and exchange-like transactions, the guidance provided in item 150 of the 2nd GASB 34 Q&A,¹¹ and professional judgment, given the facts and circumstances surrounding the transactions, affect the determination of whether certain fees arise in whole or in part from nonexchange transactions or, instead, exchange or exchange-like transactions. This may affect, for example, regulatory and professional license and permit fees, system development fees, and impact fees. (System development fees are charged to join or extend an existing utility system; they also are known as tap or connection fees. System development fees may relate to the cost to physically connect to the system, or they may substantially exceed the cost to connect. Governments charge property developers impact fees to help defray the government's costs that result from increased development.)

6.49 Some user fees are billed and collected essentially at the same time they are earned, such as fees for some parking garages or toll roads. Other user fees, such as charges for some electric, water, and gas utility services, are billed and collected after the service is delivered (and thus after the exchange takes place). Still other user fees, such as charges for some sewer and trash utility services, are billed and collected before the service is delivered (and thus before the exchange takes place). When user fees are not billed and collected at the same time they are earned, a government may need to record receivables for billed services or liabilities for advance payments, depending on whether the fees are earned before they are billed and collected or vice versa. (See also the discussion in Chapter 8 concerning customer and developer deposits.) Further, depending on the billing characteristics, the amounts reported as receivables may need to go beyond simply the amounts billed but not collected. For example, if utility customers are billed at the end of each quarter based on actual (not estimated) meter readings, but the meter readings are spread evenly throughout the quarter, an average of forty-five days' service for the entire customer base is unbilled at the end of the accounting period. Also, consideration may be required as to the characteristics of the billing period, such as seasonal usage.

6.50 If a government uses an enterprise fund to account for rate-regulated services of the type and under the conditions specified in FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation* (see paragraph 6.51), GASB Statement No. 34 permits the government to apply the provisions of FASB Statement No. 71 and its related pronouncements issued on or before November 30, 1989, to that fund and also to the activities of that fund when they are reported in the government-wide financial statements. (In addition, enterprise funds and the resulting reporting in the government-wide financial statements have an option to apply *all* FASB pronouncements issued after November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. See the discussion of the application of private-sector pronouncements in Chapter 2, "Financial Reporting.")

¹¹ Item 150 of the 2nd GASB 34 Q&A indicates that drivers' licenses and business permits generally are exchange or exchange-like transactions because the cost of a license or permit does not exceed the value of the services and rights received in exchange.

6.51 Generally, the type of regulation covered by FASB Statement No. 71, as amended and interpreted, permits rates (prices) to be set at levels intended to recover the estimated costs of providing regulated services or products. In rate-regulated enterprises, revenues intended to cover some costs are provided either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, enterprises are required to capitalize those costs. If current recovery is provided for costs that are expected to be incurred in the future, enterprises are required to recognize those current receipts as liabilities. (See the further discussion of the accounting for rate-regulated services in the section on utilities in Chapter 12, "Special-Purpose and State Governments.")

Risk Financing Activities

6.52 Chapter 8 discusses the accounting, financial reporting, and auditing considerations for an entity's risk financing activities, including recognition of interfund charges received by the general fund or internal service funds that account for those risk financing activities. In addition, Chapter 12 discusses the accounting, financial reporting, and auditing considerations for public entity risk pools, including revenue recognition.

Defined Benefit Pension Plan Contributions

6.53 Chapter 12 discusses the accounting, financial reporting, and auditing considerations for public employee retirement systems (PERS), including contributions received by defined benefit pension plans.

Sales and Leases of Capital Assets

6.54 Reported amounts arising from sales of capital assets should be recognized when the exchange takes place; that is, when title to the property transfers. In the government-wide, proprietary fund, and fiduciary fund financial statements, the amount recognized should be the difference between the sales price of the asset and its carrying amount. As shown in the nonauthoritative illustrative financial statements in GASB Statement No. 34, the amount recognized in the governmental fund financial statements generally is the proceeds from the sale of the asset. Proceeds from the sale of general capital assets normally are recorded in the general fund, although some bond indentures, state or local laws, or grant contracts may require that the proceeds be recorded in a related debt service fund, special revenue fund, or capital projects fund.

6.55 The accounting and financial reporting for lease agreements is described in NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, as amended by GASB Statements No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, and No. 14, *The Financial Reporting Entity*. NCGA Statement 5, as amended, provides that the criteria of FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, are the guidelines for accounting and financial reporting for lease agreements in which the government is the lessor, except for operating leases with scheduled rent increases. (Chapters 7 and 8 discuss the accounting and financial reporting for capital and operating leases, respectively, when the government is the lessee. Those chapters provide certain details on the provisions of NCGA Statement 5, as amended, GASB Statement No. 13, and FASB Statement No. 13, as amended and interpreted. The Chapter 12 section on financing authorities discusses leases between a primary government and its component units.)

Special Assessments

6.56 Service-type special assessments usually involve the provision of basic or additional services to property owners on an assessment basis. The types of services provided under these arrangements include street lighting and street cleaning, weed cutting, and snow removal. Service-type special assessments that are exchange or exchange-like transactions should be accounted for like user fees in that accrual-based revenue should be recognized when the exchange takes place. Revenues from service-type special assessments that are nonexchange transactions should be recognized in accordance with the guidance in GASB Statement No. 33. For the fund financial statements, GASB Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, paragraph 14, states that service-type special assessment transactions should be reported in the fund type that best reflects the nature of the transactions, usually the general fund, a special revenue fund, or an enterprise fund.

6.57 Governments sometimes provide capital improvements to benefit a particular group of property owners rather than the general citizenry by creating special assessment districts, providing or arranging financing, and billing and collecting the assessments. The payments made by the property owners who benefit are known as capital improvement special assessments. The receipt of capital improvement special assessments and the payment of the related debt are accounted for differently depending on whether the government is obligated in some manner to assume the payment of related debt service in the event of default by the property owners, as defined in GASB Statement No. 6, paragraph 16. If the government is not obligated in some manner to assume the payment of special assessment debt if property owners default, the receipt of the assessments and the payment of the related debt are accounted for in an agency fund.

6.58 However, if the government is obligated in some manner to assume the payment of special assessment debt in the event of default by the property owners, GASB Statement No. 6, paragraph 15, states that the receipt of the assessments and the payment of the related debt should be reported in a debt service fund, if one is required by NCGA Statement 1, paragraph 30. Revenue from capital improvement special assessment transactions that are exchange or exchange-like transactions should be recognized on the accrual basis of accounting. Capital improvement special assessment receivables should be reported at the time of the levy. (See the additional discussion of capital improvement special assessment capital assets in Chapter 7, "Capital Assets," and special assessment debt in Chapter 8.)

Amounts Collected for Individuals, Other Entities, or Other Funds

6.59 Some governments collect and distribute cash and other assets for the benefit of individuals or other entities, including other governments. As examples, a state social services department may collect child support payments from noncustodial parents to distribute to custodial parents, or a county tax collector may collect property taxes from property owners and distribute those taxes among the taxing jurisdictions within the county. Such transactions often are reported in private-purpose trust funds or agency funds. Private-purpose trust funds generally are distinguished from agency funds by the existence of a trust agreement, the degree of management involvement, and the length of time that the resources are held. Private-purpose trust and agency funds use the accrual basis of accounting to recognize resource inflows. (See the further discussion of these fund types in Chapter 2.)

6.60 Agency funds involve accounting for amounts held as an agent for only individuals, private organizations, or other governments. If any amounts in agency funds are held for other funds of the government, the portion that pertains to other funds should be reported as assets in the appropriate funds, not in agency funds.

Activity Statement Classifications

Government-Wide Statement of Activities

6.61 GASB Statement No. 34 requires reported resource inflows to be classified as program or general revenues unless they are required to be classified as contributions to term and permanent endowment principal, contributions to permanent fund principal, special items, or extraordinary items. See the GASB-established formatting requirements for the government-wide statement of activities in Chapter 2.

6.62 GASB Statement No. 34, paragraph 47, provides general rules for whether four basic sources of revenues are considered program or general revenues, as indicated in Table 6.2:

Table 6.2

Program or General Revenues	
Revenue Source	Revenue Type
Those who purchase, use, or directly benefit from the program's goods or services	Always program revenue
Parties outside the reporting government's citizens as a whole	Program revenue if restricted to a specific program; general revenue if unrestricted
All the reporting government's taxpayers	Always general revenue, even if restricted to a specific program
The governmental entity itself, for example, through investing	Usually general revenue

6.63 Program revenues derive directly from the program itself or from parties outside the reporting government's taxpayers or citizens as a whole. Program revenues are separately classified in three categories—(a) charges for services, (b) program-specific operating grants and contributions, and (c) program-specific capital grants and contributions.¹²

- Charges for services include transactions in which customers, applicants, or others purchase, use, or directly benefit from the goods, services, or privileges provided, or are otherwise affected by the services. Examples include charges for specific services, such as water use or trash collection; licenses and permits (such as dog licenses, liquor licenses, and building permits); assessments for street cleaning or special street lighting; fines, and forfeitures; and payments from other governments that are exchange transactions. This type of program revenue should be reported in the function that generates the

¹² GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 48, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, paragraph 12, footnote d, indicates that more than one column may be used to display components of a program revenue category. Further, governments may use more-descriptive category headings to explain the types of program revenues being reported.

revenue, even if the revenue's use is restricted to another program. If it is difficult or impractical to identify the function that generates a program revenue, GASB Statement No. 34, as amended, requires the government to adopt a classification policy for assigning those revenues to a function and to apply that policy consistently.

- Program-specific operating and capital grants and contributions include revenues that arise from government-mandated and voluntary nonexchange transactions with other governments, organizations, or individuals that are restricted for use in a particular program. This type of program revenue should be reported in the function to which the revenue's use is restricted. Capital grants and contributions consist of capital assets or resources that are restricted for capital purposes—to purchase, construct, or renovate capital assets associated with a specific program. Grants and contributions that may be used either for operating expenses or for capital expenditures of the program at the discretion of the reporting government should be reported as operating grants.

6.64 Multipurpose grants (those that provide financing for more than one program) should be reported as program revenue if the amounts restricted to each program are specifically identified in either the grant award or the grant application on which the award was based. Multipurpose grants that do not provide for specific identification of the programs and amounts should be reported as general revenues. (Item 62 of the 2nd GASB 34 Q&A discusses the classification of revenue from program-restricted multipurpose grants when an entity reports its operations in functional categories.)

6.65 All revenues are general revenues unless they are required to be reported as program revenues, contributions to term and permanent endowments, contributions to permanent fund principal, special items, or extraordinary items. All taxes, even those that are levied for a specific purpose, are general revenues and should be reported by type of tax, for example, sales tax, property tax, franchise tax, income tax. (The GASB 34 Q&A, items 128 and 129, explains that special assessments, unlike property taxes, are considered program revenues rather than general revenues.) General revenues should be reported after the total net expense of the government's functions.

6.66 Contributions to term and permanent endowments, contributions to permanent fund principal, special items, and extraordinary items each should be reported after the total net expense of the government's functions. Special items are transactions or other events within the control of management that are either unusual in nature or infrequent in occurrence. (APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended and interpreted, defines the terms *unusual in nature and infrequency of occurrence*.) Extraordinary items are transactions or other events that are both unusual in nature and infrequent in occurrence. GASB Statement No. 34, paragraph 56, requires special items to be reported before extraordinary items. The GASB 34 Q&A provides examples of special and extraordinary items.

6.67 The classification requirements for resource inflows apply to all amounts reported in the statement of activities, including amounts reported for discretely presented component units. However, because GASB Statement No. 34 does not require special-purpose governments engaged only in business-type activities to present government-wide financial statements (see Chapter 12), those classifications may not be presented in the stand-alone financial

statements of certain component units. Some primary governments may require their component units to include that information in their basic financial statements so that audited information is available for the reporting entity's financial statements. Other governments will infer that information from the component unit financial statements as discussed in item 50 of the 2nd GASB 34 Q&A.

6.68 The GASB 34 Q&A and the 2nd GASB 34 Q&A provide additional examples of the classification of specific types of revenues as program revenues or general revenues.

Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balances

6.69 NCGA Statement 1, paragraph 110, provides that governmental fund revenues should be classified in the statement of revenues, expenditures, and changes in fund balances by major revenue source, such as taxes, licenses and permits, intergovernmental revenues, charges for services, fines and forfeits, and miscellaneous. Revenues may be further classified by organization units—departments, bureaus, divisions, or other administrative agencies. Certain resource inflows are reported as other financing sources. Sales of capital assets are reported as other financing sources unless the sale meets the criteria for reporting as a special item (see paragraph 6.66 for the definition of special items). Other financing sources also are reported for the financing of capital assets under capital leases and the issuance of debt, as discussed in Chapters 7 and 8, respectively. See the GASB-established formatting requirements for the governmental fund statement of revenues, expenses, and changes in fund balances in Chapter 2.

6.70 Special and extraordinary items (see paragraph 6.66 for definitions), including those resulting from resource inflows, should be reported separately after “other financing sources and uses.” If both special and extraordinary items occur during the same period, they should be reported separately within a “special and extraordinary items” classification.

Proprietary Fund Statement of Revenues, Expenses, and Changes in Fund Net Assets

6.71 GASB Statement No. 34, paragraph 100, requires the proprietary fund statement of revenues, expenses, and changes in fund net assets (or fund equity) to:

- Report revenues by major source.
- Identify revenues used as security for revenue bonds.
- Report revenues either (a) net of discounts and allowances with disclosure of the discount or allowance amount parenthetically on the face of the statement or in a note to the financial statements or (b) gross with the related discounts and allowances reported directly beneath the revenue amount.
- Distinguish between operating and nonoperating revenues and expenses (as discussed in paragraph 6.72 through 6.74).
- Report revenues from capital contributions and additions to the principal of permanent and term endowments and special and extraordinary items, including those resulting from resource inflows, separately after nonoperating revenues and expenses.

See the GASB-established formatting requirements for the proprietary fund statement of revenues, expenses, and changes in fund net assets in Chapter 2.

6.72 GASB Statement No. 34, paragraph 102, states that governments should establish a definition of operating revenues and expenses that is appropriate to the nature of the activity being reported. It also states that a consideration for defining operating revenues and expenses is how individual transactions are categorized in the fund's statement of cash flows. Those general guidelines tie a proprietary fund's operating revenues and expenses to its main purpose. For example, greens fees and the expenses associated with maintaining the course could be operating revenues and expenses for a golf course, while water billings and the expenses associated with providing the water could be operating revenues and expenses for a water utility.

6.73 GASB Statement No. 34, paragraph 102 and footnote 42, indicates that nonoperating revenues generally should include revenues from taxes, certain nonexchange fees and charges, and interest. Nonoperating revenues also generally should include revenues from appropriations between primary governments and their component units, contributions, grants, entitlements, and shared revenues for operating purposes or that may be used, at the recipient's discretion, for either operating purposes or capital outlay.¹³ However, those types of revenue should be classified as operating revenue when they meet the definition of operating revenue that is appropriate to the nature of the activity as explained in paragraph 6.72. For example, footnote 42 to GASB Statement No. 34 states that interest revenue and expense transactions should be reported as operating revenue and expense by a proprietary fund established to provide loans to first-time homeowners. Similarly, GASB Statement No. 9, paragraph 17, states that cash inflows from operating activities include cash receipts from grants for specific activities that are considered to be operating activities of the grantor government. (A grant arrangement of this type is essentially the same as a contract for services.) If a government classifies certain grants in its statement of cash flows as cash inflows from operating activities, it may be appropriate to classify those same grants as operating revenues.

6.74 The classification of system development fees (see paragraph 6.48) differs among entities. In some instances, fees related to the physical connection to the system are recorded as operating income, and the related costs are expensed. In other cases, amounts assessed that substantially exceed the cost to connect are recorded as capital contributions, reported separately after nonoperating revenues and expenses, or the entire fee is recorded as nonoperating revenue.

Fiduciary Fund Statements of Changes in Fiduciary Net Assets

6.75 The fiduciary fund statement of changes in fiduciary net assets classifies all resource inflows as additions, not as revenues. Chapter 12 discusses specific provisions for the classifications of additions in the statement of changes in plan net assets for defined benefit pension plans and postemployment healthcare plans.

6.76 Agency funds are not reported in the statement of changes in fiduciary net assets. However, a combining statement of changes in assets and liabilities—all agency funds should be presented as supplementary information other than required supplementary information (RSI), known as SI, when

¹³ Items 213 and 215 of the GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A) support this classification requirement. Those items also indicate that revenues that are restricted for the acquisition or construction of capital assets should be classified as capital contributions, reported separately after nonoperating revenues and expenses, not as nonoperating revenues.

a Comprehensive Annual Financial Report (CAFR) is presented. (The auditor's responsibility for and reporting on SI are discussed in Chapters 4 and 14, "Audit Reporting," respectively.)

Financial Position Statement Classifications

6.77 All receivables should be reported net of estimated uncollectible amounts. (APB Opinion No. 12, *Omnibus Opinion—1967*, paragraphs 2 and 3, discusses the display of asset valuation allowances.) Applying the provisions of APB Opinion No. 12, paragraph 3, the allowance for estimated uncollectible receivables should be disclosed in the face of the financial statement (either parenthetically or as a separate line item) or in the notes to the financial statements.

6.78 GASB Statement No. 34 provides guidance relating to reporting restricted assets, including restricted receivables, in the government-wide and proprietary fund financial statements. See the discussion of those requirements in Chapter 2.

Disclosures

6.79 The following are among the disclosures required for revenues and receivables:¹⁴

- The accounting policies used for recognizing revenues (NCGA Statement 1, paragraph 69, and APB Opinion No. 22, *Disclosure of Accounting Policies*)
- A description of the types of transactions included in program revenues in the statement of activities (GASB Statement No. 34, paragraph 115)
- Nonexchange revenues that are not recognizable because they are not measurable (GASB Statement No. 33, paragraph 11)
- Various data concerning property taxes as provided in NCGA Interpretation 3, paragraph 11, including details of the governmental unit's property tax calendar (such as lien dates, levy dates, due dates, and collection dates)
- The length of time used to define *available* for purposes of revenue recognition in the governmental fund financial statements (GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 7)
- If, because of unusual circumstances, the facts justify using a period greater than sixty days as the availability period for the modified accrual recognition of property taxes, the period being used and the facts that justify it (NCGA Interpretation 3, paragraph 8)
- The policy for defining operating and nonoperating revenues of proprietary funds (GASB Statement No. 34, paragraphs 102 and 115)
- Details about receivables aggregated in the financial statements when those aggregations obscure significant components of the receivables (GASB Statement No. 38, paragraph 13)¹⁵

¹⁴ Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in Chapter 3, "The Financial Reporting Entity."

¹⁵ Governments that are required to apply GASB Statement No. 34 for financial statements for periods beginning after June 15, 2001 (phase 1 governments) are not required to apply this provision of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, until financial statements for periods beginning after June 15, 2002, although earlier application is encouraged.

- Significant receivable balances not expected to be collected within one year of the financial statement date (GASB Statement No. 38, paragraph 13)¹⁶
- The amounts recognized as revenue for on-behalf payments for fringe benefits and salaries and, for those on-behalf payments that are pension plan contributions for which the entity is not legally responsible, the names of the plan and of the entity that makes the contributions (GASB Statement No. 24, paragraph 12)
- The amount of special assessment receivables that are delinquent, if not separately displayed on the face of the financial statements (GASB Statement No. 6, paragraph 20)
- Any significant transactions or other events that are either unusual or infrequent but not within the control of management (GASB Statement No. 34, paragraph 56)

Auditing Considerations

6.80 The audit objectives for revenues and receivables (and for deferred revenues, which represent the difference between revenue and amounts received or receivable), categorized by financial statement assertion, are as follows:

- *Existence or Occurrence.* Revenues represent valid current-period transactions. Receivables represent valid amounts uncollected at the end of the period. Deferred revenues represent amounts received or receivable that have not met the criteria for revenue recognition.
- *Completeness.* Revenues, receivables, and deferred revenues are complete.
- *Rights and Obligations.* The government has satisfied the relevant legal and contractual provisions to receive all recorded revenues, receivables, and deferred revenues. Receivables are unencumbered by pledge or lien.
- *Valuation or Allocation.* Revenues are billed and recorded at the correct amounts, and receivables and deferred revenues are stated at the net realizable amounts.
- *Presentation and Disclosure.* Revenues, deferred revenues, and receivables and related receivable valuation allowances are properly classified in the financial statements, and related disclosures are made in conformity with GAAP, consistently applied.

6.81 The auditor might determine the government's various revenue sources by reading legal documents, such as budgets, enabling legislation, and grant agreements; asking appropriate officials about revenue sources; and reviewing the financial statements of the prior period and the draft financial statements or other accounting information for the current period. After identifying the sources and amounts of revenues, the auditor should obtain an understanding of internal control over and assess control risk for the processes for billing, accounting for, and collecting major revenue sources.

6.82 The auditor should be aware of the possibility of the decentralization of the entity's billing, accounting, and collection functions relating to revenues

¹⁶ See footnote 15.

and receivables, perform procedures to identify the various locations that conduct such functions, and assess control risk at each location that may materially affect the financial statement assertions. If the government's revenues are collected by another entity, the auditor should consider the guidance of SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). Also see the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as amended* for clarification regarding guidance in SAS No. 70, as amended.

6.83 In auditing revenues, receivables, and deferred revenues, it usually is more efficient and effective to plan to integrate the audit of receivables with the substantiation of revenues and deferred revenues. Audit procedures should be designed to achieve audit objectives, including obtaining reasonable assurance about whether the financial statements are free of material misstatements arising from violations of compliance requirements that have a direct and material effect on the determination of financial statement amounts. (See the discussion of the auditor's responsibility in this regard in Chapter 4.) Further, the auditor needs to determine that adequate procedures are performed related to activity and balances in each of those opinion units with material revenues, receivables, or deferred revenues. (See the discussion of opinion units in Chapter 4.) The auditor should consider the procedures discussed in the following paragraphs when planning the audit of revenues, receivables, and deferred revenues.

6.84 The auditor should obtain an understanding of the government's internal control over revenues, receivables, and deferred revenues. In addition to standard internal control features for those accounts, features that are unique or significant in government may include the following:

- Specific written procedures to authorize and approve abatements, exonerations, and refunds of taxes (including penalties and interest), service charges, and other applicable revenue transactions
- Procedures to ensure that tax, fee, and service rates, exemptions, and discounts are authorized and periodically reviewed by the governing board
- Procedures to compare the detailed lists of current taxpayers; properties subject to property taxes and special assessments; grantors and contributors; service recipients; pension plan contributors; and so forth to (a) the prior-period list, and to identify and investigate those payers that are not included on the current list, and (b) corroborating information, such as sales tax vendor files, real estate assessment files, and permit holders, for completeness and validity
- Procedures to compare actual revenues to budgeted amounts and to investigate significant variances
- Periodic redetermination of property value assessments in accordance with legal provisions, with prompt adjustment of property records
- Procedures to accurately update property records for additions, deletions, transfers, and abatements on a timely basis
- Appropriate legal procedures for liens, tax sales, and foreclosures
- Procedures to total individual tax bills and to compare them to the total tax levy
- Procedures to estimate amounts receivable and revenues from derived tax revenues

- Review of tax returns for accuracy, and supervisory review and approval of large or unusual refund claims
- Conducting audits of tax returns on a scheduled basis
- Procedures to ensure that the entity complies with the eligibility requirements, purpose restrictions, and other compliance requirements of grants, private donations, and trust agreements (See also Chapter 8.)
- Procedures to ensure that amounts receivable for fines and fees are properly recorded on a timely basis and evaluated for collectibility
- Procedures to ensure that all utility customers have meters (if applicable), that meters are read, that unusual or illogical readings are investigated, and that the aggregate use indicated by the reading of individual meters is reconcilable to the total use for the system
- Procedures to recognize and classify resource inflows in conformity with GAAP
- Procedures to ensure that enterprise funds that apply the provisions of FASB Statement No. 71, as amended and interpreted, comply with the requirements of those standards
- Procedures to ensure that the entity conforms with the GASB's recognition and reporting requirements for pass-through grants and on-behalf payments for fringe benefits and salaries
- Adequate physical controls over revenues that are collected in cash, such as from public transportation fare-boxes, parking meters, and licenses and permits
- Monitoring of revenues collected for the entity by another government (or another collection agent) for timely receipt and reasonable amounts
- Procedures to ensure that amounts collected by the entity for other governments are segregated and remitted on a timely basis
- Procedures to ensure that all GAAP-required disclosures for revenues and receivables are made in the financial statements

Confirmations

6.85 Many revenues and receivables are susceptible to confirmation. Confirmation of receivables provides evidence about the existence and ownership of a receivable but provides little evidence about collectibility. Collectibility usually is evaluated through the examination of subsequent receipts and historical trends. See SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), for guidance about the confirmation process.¹⁷ In some cases, audit evidence is obtained more readily through the application of alternative audit procedures.

6.86 In paragraphs 34 and 35, SAS No. 67 states that there is a presumption that the auditor will request the confirmation of accounts receivable (defined as the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business) during an audit. However, if one of the three conditions listed in paragraph 34 of SAS No. 67 exist, confirmations of accounts receivable need not be requested, but the auditor should document how he or she overcame the presumption that the receivables

¹⁷ Additional guidance also is available in the AICPA Auditing Procedure Study, *Confirmation of Accounts Receivable* (second edition, revised).

would be confirmed. Note that the presumption in SAS No. 67 that the auditor will request confirmations applies only to accounts receivables, as defined, not to other receivables, such as those for intergovernmental revenues and taxes. However, auditors could consider applying the guidance of SAS No. 67, paragraphs 34 and 35, to other types of receivables.

6.87 When a receivable balance is composed of a few large balances, which may be the case with receivables arising from intergovernmental revenues and revenues collected by other entities, the auditor may confirm the amounts transmitted to the auditee during the fiscal period as well as the unremitted amounts to be recorded as receivables.

6.88 Often, the confirmation of receivable balances is not effective when the receivable balance is composed of many small balances, which may be the case with receivables arising from property taxes, special assessments, fees, and private donations. In such cases, response rates to properly designed confirmations may be inadequate or unreliable. However, the auditor should use professional judgment to determine whether to confirm those balances and whether to follow the provisions of SAS No. 67 concerning documentation, as discussed in paragraph 6.86, if those receivables are not confirmed.

Estimates

6.89 Certain receivables, for example, some of those arising from revenues from taxpayer-assessed taxes such as sales and income taxes, are not composed of amounts due from individual taxpayers but rather are estimates of the amount due from the taxpayer group as a whole. (A government's estimation process for certain taxes may have to consider final settlement amounts for refunds as well as additional payments. See paragraph 6.26). In that situation, the auditor should consider evaluating the reasonableness of the estimation process used to record the receivable. Governments may use various methods to make those estimates, often considering historical information as well as current facts and circumstances (such as tax and withholding rate changes and changes in economic conditions) that affect historical information. Among other factors the auditor might consider are the entity's internal control over the collection of current and delinquent income taxes, the methods it uses for determining population completeness (for example, whether all citizens are filing income tax returns), and its audit and follow-up procedures related to income tax returns filed. However, it usually is not possible to establish conclusively whether all individuals or entities are reporting and paying all the taxes due, or whether the government's enforcement or discovery procedures are effective. To do so would constitute performance auditing and thus go beyond the auditor's responsibilities in relation to an audit of the financial statements. Instead, the auditor would be considering whether reasonable efforts are being made to minimize nonpayment.

6.90 GASB Statement No. 33 requires recognition of nonexchange transactions in the financial statements unless the transactions are not measurable (reasonably estimable) or are not probable of collection. It also requires recognition of property tax receivables in the period when an enforceable legal claim to the assets arises. If a government's enforceable legal claim to taxable property arises before taxes are levied, the property tax receivable may or may not be reasonably estimable in advance of the levy. In that situation, the auditor should consider evaluating a government's accounting policies and procedures for estimating property tax receivables and for disclosure if the receivables are not recognizable because they are not measurable.

Confidential Records

6.91 In some situations, an auditor may be denied access to certain records underlying a government's revenue amounts (such as income tax returns) because of legal provisions concerning confidentiality. Chapter 4 discusses how an auditor's lack of access to records may constitute a limitation on the scope of the audit if adequate alternative procedures are not available.

Other Procedures

6.92 In addition to standard audit procedures for revenues, receivables, and deferred revenues, other procedures that are unique or significant in government may include the following:

- Reviewing underlying documentation (such as statutes and regulations, governing board minutes, grant contracts and donor letters, contracts to lease or sell capital assets) for support of tax, fine, fee, and service rates and revenue amounts
- Determining whether tax, fee, and service rates are billed consistently and whether rate changes are incorporated into the billing system on a timely basis
- Summarizing revenues by source and type and comparing recorded revenue to the current budget and to prior-period actual amounts, and obtaining and evaluating explanations of significant variances
- Reviewing abatements, exonerations, refunds, and similar items for proper approval
- For various revenue types and individual revenue amounts, testing compliance with the legal and contractual provisions that could have a direct and material effect on the determination of financial statement amounts. (See paragraph 6.06 and Chapter 8.)
- Examining substantiation for the tax exemptions of properties and organizations
- Reviewing a sample of taxpayer-assessed tax returns and verifying that the tax liability was calculated in accordance with governing laws and regulations (see paragraph 6.91)
- Considering whether the entity's revenue recognition and classification principles conform with GAAP and are consistently applied
- Evaluating the adequacy of allowances for uncollectible revenues, including evaluating that the entity has filed liens or taken other legally required steps to ensure the collectibility of revenues (see paragraph 6.07)
- Evaluating the adequacy of amounts for probable revenue-related refunds, such as for income or other taxes
- Determining whether revenues are properly recorded for amounts collected by another entity.
- Determining whether amounts collected by the entity for other governments are properly segregated and accounted for
- Determining whether the entity's revenue and receivable disclosures conform with GAAP

Chapter 7

Capital Assets

Nature of Transactions

7.01 According to Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, paragraph 19, capital assets include land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.¹ Infrastructure assets are long-lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure assets are roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems. Buildings, except those that are an ancillary part of a network of infrastructure assets, are not considered infrastructure assets.

7.02 How capital assets are accounted for in the different basic financial statements depends on the measurement focus used. With certain exceptions discussed later in this chapter:

- Capital assets acquired with governmental fund resources are accounted for as capital expenditures and are not capitalized in the governmental fund financial statements. Those capital assets are referred to as *general capital assets*. General capital assets also include capital assets associated with governmental funds that are received through donation, even though not reported as capital expenditures or capitalized in the governmental funds.
- Capital assets acquired with proprietary or fiduciary fund resources or donated to those funds are capitalized in those funds and depreciated in those funds over their estimated useful lives.
- In the government-wide financial statements, capital assets, including general capital assets, are capitalized and depreciated over their estimated useful lives.

This chapter further discusses the accounting and financial reporting for capital assets in paragraphs 7.10 through 7.51. GASB staff documents *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A) and *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A) includes additional details about defining, accounting for, and reporting on capital assets.

¹ The GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A), item 26, indicates that library books, depending on their nature, may be depreciable capital assets, or works of art or historical treasures (see paragraph 7.23).

Capital Asset Management

7.03 Governments usually acquire general capital assets with the resources of the general, special revenue, capital projects, and permanent funds. A government's budgeting policies usually affect how the government finances and accounts for general capital asset acquisitions of different sizes and types:

- Governments often budget for and acquire small purchases of personal property, such as vehicles, machinery, and equipment, through the general fund, special revenue funds, or permanent funds. Those general capital assets normally are financed with, for example, tax revenues, intergovernmental grants, donations from nongovernmental entities, and capital leases.
- Governments often budget for and acquire major capital facilities, such as buildings, bridges, streets, parks, and storm drains, through capital project funds. Those general capital assets normally are financed with, for example, the proceeds of bond issues, special assessment revenues, intergovernmental grants, donations from property developers or other nongovernmental entities, or transfers from other of the government's funds.

7.04 Governments also acquire capital assets for proprietary funds from the same types of sources that finance general capital assets as well as from user fees. Proprietary fund capital assets also may be acquired through governmental fund resources and contributed to the proprietary funds. This often is the method of financing used for newly established proprietary funds.

7.05 Many fiduciary funds do not have capital assets, but some do. For example, public employee retirement systems (PERS) often own the buildings in which they operate, and own the furniture, fixtures, and equipment that they use in operations.

7.06 Governments adopt capitalization threshold policies to establish the per-unit cost that they will use to identify the capital assets they will report in their financial statements. A low capitalization threshold generally will increase the number of items capitalized, while a high capitalization threshold has the opposite effect. Typically, a government's capitalization threshold correlates with its size. Management usually sets the capitalization threshold at a level acceptable to its governing board and citizenry, and considering the various compliance requirements that affect capital assets. For example, many grantors require that detailed records be maintained on capital assets acquired with grant moneys that cost in excess of an established amount. A recipient government may decide to coordinate its financial reporting capitalization level with those grant provisions.

7.07 Governments may establish different capitalization thresholds for different types of capital assets. For example, they may establish a higher threshold for infrastructure assets (given their large dollar cost and normally stationary nature) and a lower one for other capital assets such as vehicles, machinery, and equipment.

7.08 Governments often safeguard their capital assets by affixing identification tags (as appropriate), maintaining detailed records, and conducting periodic physical inspections, adjusting the records accordingly. Government may inspect capital assets that are more susceptible to theft or other misappropriation, such as personal property that is portable and conducive to personal use or to sale, more frequently than capital assets that are not. Many

governments extend their capital asset management processes to certain capital assets that do not qualify for capitalization for financial reporting purposes, such as computers and other electronic equipment that cost less than the capitalization threshold but that are susceptible to misappropriation, and expensive or otherwise valuable works of art and historical treasures that are not subject to capitalization (see paragraph 7.23).

Compliance Considerations

7.09 Legal and contractual provisions often govern a government's acquisition and disposition of capital assets. For example, capital asset acquisitions generally require budgetary authorization and governing board approval. Also, there often are legal provisions governing procedures for bidding and awarding contracts, and for selling at auction capital assets that are no longer used or for contributing those assets to other governments or to not-for-profit organizations. If funding is derived from a bond issue, there often are bond covenant compliance requirements. If part of the funding is derived from intergovernmental revenues or donations from nongovernmental entities, there may be compliance requirements that relate not only to the acquisition and disposition of capital assets but also to the maintenance of and recordkeeping for the assets. Although a government should be concerned with all compliance requirements, generally accepted auditing standards (GAAS) focus the auditor's concern on those compliance requirements that could have a direct and material effect on the determination of financial statement amounts. (See the further discussion of the auditor's responsibility in this regard in Chapter 4, "Planning the Audit.")

Accounting and Financial Reporting Considerations

7.10 Paragraphs 7.13 through 7.31 discuss the general accounting and financial statement presentation standards for capital assets depending on the financial statements involved. (Tables 7.1 and 7.2 in paragraphs 7.11 and 7.12 summarize certain of those standards.) Paragraphs 7.32 through 7.47 discuss specific accounting and financial reporting standards for capital leases, the modified approach for infrastructure assets, interfund movements of capital assets, and capital assets used in landfills. Paragraphs 7.48 through 7.51 discuss requirements for (a) disclosures about capital assets in the notes to the financial statements and (b) the management's discussion and analysis.

7.11 Table 7.1 provides an overview of the accounting in the government-wide statement of activities, the proprietary fund statement of revenues, expenses, and changes in net assets, and the statement of changes in fiduciary net assets² for the use of capital assets. Those activity statements use the economic resources measurement focus and accrual basis of accounting. The governmental funds, which use the current financial resources measurement focus and modified accrual basis of accounting, do not report the use of capital assets. Instead, capital expenditures are reported in the period the liability is incurred.

² This presentation relates only to the trust fund types. The statement of changes in fiduciary net assets does not include agency funds. See Chapter 2, "Financial Reporting."

Table 7.1

Accounting for the Use of Capital Assets

Type of Capital Asset	Accounting
Inexhaustible ^a capital assets, such as land and certain land improvements and certain works of art, historical treasures, and similar assets, ^b as well as construction in progress ^c	No use of the asset is recorded
Infrastructure assets	
Eligible infrastructure assets ^d	Depreciation method or the modified approach
Other than eligible infrastructure assets	Depreciation method
Other exhaustible capital assets, such as buildings, building improvements, vehicles, machinery, equipment, and certain works of art, historical treasures, and similar assets	Depreciation method

^a An inexhaustible capital asset is one whose economic benefit or service potential is used up so slowly that its estimated useful life is extraordinarily long.^c

^b GASB Statement No. 34, paragraph 27, establishes the criteria under which certain works of art, historical treasures, and similar assets are not required to be capitalized, although capitalization is encouraged. See paragraph 7.23.

^c These provisions come from the GASB 34 Q&A rather than from GASB Statement No. 34.

^d Eligible infrastructure assets are infrastructure assets that are part of a network or subsystem of a network (see paragraph 7.19).

7.12 Table 7.2 provides an overview of capital asset reporting for different situations.

Table 7.2

Capital Asset Reporting

<i>Activity</i>	<i>Government-wide Financial Statements</i>	<i>Governmental Fund Financial Statements</i>	<i>Proprietary Fund Financial Statements</i>	<i>Fiduciary Fund Financial Statements^a</i>
Capital assets purchased or received through donation (except noncapitalized works of art, historical treasures, and similar assets ^b)	<ul style="list-style-type: none"> • Capitalize assets • Report donation as revenue or contribution to term or permanent endowment 	<ul style="list-style-type: none"> • Report assets purchased as an expenditure • Reporting donated assets as assets or as a financial resource inflow or outflow may depend on whether the assets are held for use (See paragraph 7.29 and footnote 9.) 	<ul style="list-style-type: none"> • Capitalize assets • Report donation as capital contribution or addition to term or permanent endowment 	<ul style="list-style-type: none"> • Capitalize assets • Report donation as addition
Noncapitalized works of art, historical treasures, and similar assets ^b purchased or received through donation	<ul style="list-style-type: none"> • Report assets purchased and received through donation as an expense • Report donation as revenue or contribution to term or permanent endowment 	<ul style="list-style-type: none"> • Report assets purchased as an expenditure • Reporting donated assets as assets or as a financial resource inflow or outflow may depend on whether the assets are held for use (See paragraph 7.29 and footnote 9.) 	<ul style="list-style-type: none"> • Report assets purchased and received through donation as an expense • Report donations as capital contribution or addition to term or permanent endowment 	<ul style="list-style-type: none"> • Report assets purchased and received through donation as a deduction • Report donation as addition
Capital assets accounted for using the depreciation method (Table 7.1 in paragraph 7.11 identifies these assets.)				
Use of exhaustible capital assets	<ul style="list-style-type: none"> • Charge depreciation expense and increase accumulated depreciation 	<ul style="list-style-type: none"> • Not applicable 	<ul style="list-style-type: none"> • Charge depreciation expense and increase accumulated depreciation 	<ul style="list-style-type: none"> • Charge depreciation deduction and increase accumulated depreciation

(continued)

^a This presentation relates only to the trust fund types. The agency funds generally do not hold long-lived assets. If they do, those assets probably would not meet the definition of capital assets, that is, they probably would not be used in operations.

^b GASB Statement No. 34, paragraph 27, establishes the criteria under which certain works of art, historical treasures, and similar assets are not required to be capitalized, although capitalization is encouraged. (See paragraph 7.23.)

<i>Activity</i>	<i>Government-wide Financial Statements</i>	<i>Governmental Fund Financial Statements</i>	<i>Proprietary Fund Financial Statements</i>	<i>Fiduciary Fund Financial Statements^a</i>
Outlays that extend the initial estimated useful lives of the assets (preservation costs) or improve their efficiency (improvements) or capacity (additions) ^c	• Capitalize and depreciate	• Report as expenditures	• Capitalize and depreciate	• Capitalize and depreciate
Outlays for repairs and maintenance ^c Infrastructure capital assets accounted for using the modified approach (Table 7.1 in paragraph 7.11 identifies these assets.)	• Report as expenses	• Report as expenditures	• Report as expenses	• Report as deductions
Use of infrastructure capital assets	• No charge for depreciation	• Not applicable	• No charge for depreciation	• No charge for depreciation
Outlays that improve the assets' efficiency (improvements) or capacity (additions)	• Capitalize	• Report as expenditures	• Capitalize	• Capitalize
Outlays that extend the estimated useful lives of the assets (preservation costs) and outlays for repairs and maintenance	• Report as expenses	• Report as expenditures	• Report as expenses	• Report as deductions
Sales and other dispositions of capital assets (See Chapter 6, "Revenues and Receivables.")	<ul style="list-style-type: none"> • Remove the assets' cost and any accumulated depreciation • Report gain or loss on sale as general revenue or general government-type expenses^{c,d} (See GASB 34 Q&A, item 131.) 	<ul style="list-style-type: none"> • Report proceeds as other financing source^d 	<ul style="list-style-type: none"> • Remove the assets' cost and any accumulated depreciation • Report gain or loss on sale as revenue or expense (usually nonoperating)^d 	<ul style="list-style-type: none"> • Remove the assets' cost and any accumulated depreciation • Report gain or loss on sale as an addition (deduction)

^c These provisions come from the GASB 34 Q&A rather than from GASB Statement No. 34.

^d The gain, loss, or proceeds also could qualify for reporting as a special item.

Accounting and Financial Statement Presentation— Government-wide Financial Statements

7.13 Capital assets are capitalized in a government's government-wide financial statements, except for certain general infrastructure assets as discussed in paragraphs 7.21 and 7.22 and certain works of art, historical treasures, and similar assets as discussed in paragraph 7.23. (*General infrastructure assets* are infrastructure assets acquired with governmental funds resources or otherwise associated with the governmental funds.) When capitalized, capital assets should be reported at actual or estimated historical cost or, if donated, at their estimated fair value at the time of acquisition.³ Historical cost should include ancillary charges necessary to place the asset into its intended location and condition for use. Ancillary charges include costs that are directly attributable to asset acquisition—such as freight and transportation charges, site preparation costs, and professional fees. The amount capitalized for donated capital assets also should include ancillary charges, if any. The cost of capital assets reported in business-type activities, which are capital assets reported in enterprise funds, should include interest capitalized in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Costs*, as amended. (FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*, which amends FASB Statement No. 34, provides in part that the interest cost of acquiring assets with the proceeds of tax-exempt borrowings should be offset by the interest earned on the temporary investment of those proceeds if those funds are externally restricted to finance the acquisition of specified qualifying assets or to service the related debt.) The cost of general capital assets should not include capitalized interest.

7.14 Often, outlays relating to capital assets are made after the assets are placed in service. GASB Statement No. 34 does not establish standards for when those costs should be capitalized or expensed, except as discussed in paragraph 7.40 relating to the modified approach. For capital assets that are depreciated, as provided in the GASB 34 Q&A, item 57, expenditures that extend the useful lives of capital assets beyond their initial estimated useful lives (preservation costs) or improve their efficiency (improvements) or capacity (additions) are capitalized, whereas expenditures for repairs and maintenance are expensed.

7.15 Infrastructure assets, like most capital assets, should be reported by the government that owns the asset.⁴ In some situations, ownership of infrastructure assets may be supported by legal documentation, such as deeds or titles conveyed when the government acquires the assets. In other situations, ownership may be supported by legal or contractual provisions that stipulate ownership under certain conditions. However, in still other situations, ownership may be unclear.

7.16 If ownership is unclear, footnote 67 to GASB Statement No. 34, paragraph 154, requires a government that has the primary responsibility for managing an infrastructure asset to report the asset in its financial statements, even if it has contracted with a third party to maintain the asset. (In

³ Donations of capital assets are reported as resource inflows in the government-wide financial statements. See Table 7.2 in paragraph 7.12 and Chapter 6, "Revenues and Receivables."

⁴ The GASB 34 Q&A, item 286, clarifies that ownership, if clear, determines which entity should report infrastructure assets.

addition, GASB Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, as amended, requires that capital assets constructed or acquired with capital improvement special assessment debt [which often are infrastructure assets] be reported as the government's capital assets.) The question of ownership and thus the issue of which entity should report particular infrastructure assets can arise in situations in which those assets have been financed by a cooperative endeavor, intergovernmental revenues, or private sources. For example, a developer may convey the continuing management of a subdivision's streets and utilities to a government. If ownership of those streets and utilities also has been conveyed to the government or if ownership is unclear, the government should report that infrastructure as its assets. However, if ownership of those assets remains with the developer or with the property owners in the subdivision and the government simply maintains the assets, the government should not report the infrastructure as its assets.

7.17 The location of infrastructure assets within a government's jurisdiction does not by itself determine what entity should report particular infrastructure assets. Roads within a county may be owned or managed by a city, the state, or a special district. Roads that are physically located within a county are not county assets, unless the county owns the roads or (if ownership is unclear) has primary responsibility for managing the roads.

7.18 On occasion, a government may transfer ownership of infrastructure assets to another government. In that situation, the transferor government should remove the net book value of those infrastructure assets from its financial statements using the provisions of GASB Statements No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, and No. 34. The transferee government also should recognize and report the receipt of the donated infrastructure assets using the provisions of GASB Statements No. 33 and No. 34. That transaction may involve the reporting of special or extraordinary items.

7.19 For purposes of applying its capital assets standards, GASB Statement No. 34 defines a *network of assets* and a *subsystem of a network of assets*. A network of assets is all assets that provide a particular type of service for a government; a network of infrastructure assets may be only one infrastructure asset that is composed of many components. For example, a network of infrastructure assets may be a dam composed of a concrete dam, a concrete spillway, and a series of locks. A subsystem of a network of assets is all assets that make up a similar portion or segment of a network of assets. For example, all the roads of a government could be considered a network of infrastructure assets. Interstate highways, state highways, and rural roads each could be considered a subsystem of that network.

7.20 GASB Statement No. 34, paragraph 20, requires capital assets that are being or that have been depreciated to be reported net of accumulated depreciation in the statement of net assets. (Accumulated depreciation may be reported on the face of the statement or disclosed in the notes.) Capital assets that are not being depreciated (see paragraph 7.24) should be reported separately if the government has a significant amount of those assets. Capital assets also may be reported in greater detail, such as by major class of asset (for example, infrastructure, buildings and improvements, vehicles, machinery, and equipment).

Retroactive Application of Standards for General Infrastructure Assets

7.21 GASB Statement No. 34 exempted smaller governments from retroactively applying its capitalization requirements to general infrastructure

assets. Governments with total annual revenues of less than \$10 million in the first fiscal year ending after June 15, 1999, were not required to retroactively apply the capitalization requirements to general infrastructure assets owned as of the date they implemented the Statement. Other governments were required to retroactively apply the capitalization requirements only to *major* general infrastructure assets (as defined in paragraph 7.22) acquired in fiscal years ending after June 30, 1980, or that were significantly reconstructed or improved during that multiyear period.⁵

7.22 GASB Statement No. 34, paragraph 156, states that the determination of major general infrastructure assets should be at the network or subsystem level (see paragraph 7.19) and should be based on the following criteria:

- The cost or estimated cost of the subsystem is expected to be at least 5 percent of the total cost of all general capital assets reported in the first fiscal year ending after June 15, 1999, or
- The cost or estimated cost of the network is expected to be at least 10 percent of the total cost of all general capital assets reported in the first fiscal year ending after June 15, 1999.

The GASB 34 Q&A, item 283, explains that those percentage calculations should be based on total reported cost of all general capital assets before any previously unrecorded infrastructure has been capitalized.

Works of Art, Historical Treasures, and Similar Assets

7.23 Unless a government meets the following conditions, it should capitalize collections of and additions to collections of works of art, historical treasures, and similar assets. Governments are encouraged, but not required, to capitalize those collections that meet all of the following conditions:

- a. Held for public exhibition, education, or research in furtherance of public service, rather than financial gain
- b. Protected, kept unencumbered, cared for, and preserved
- c. Subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.

Footnote 22 to GASB Statement No. 34, paragraph 27, requires collections already capitalized at June 30, 1999, to remain capitalized and all additions to those collections to be capitalized, even if they meet the conditions for exemption from capitalization.

Depreciation Expense

7.24 GASB Statement No. 34, paragraphs 21 and 22, requires the net cost recorded for capital assets (historical cost less estimated salvage [or residual] value⁶) to be depreciated and reported in the statement of activities over their

⁵ **Transition note:** Paragraph 7.72 discusses the effective date provisions from GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, for retroactively capitalizing general infrastructure assets.

⁶ The GASB 34 Q&A, item 45, states that residual value is the estimated fair value of a capital asset, infrastructure or otherwise, remaining at the conclusion of its estimated useful life. It also states that, in most cases, it is probable that many infrastructure assets will have no residual value, given the cost of demolition or removal.

estimated useful lives in a systematic and rational manner, unless they are inexhaustible or are infrastructure assets using the modified approach discussed in paragraphs 7.36 through 7.44. (Construction in progress also would not be depreciated; see the GASB 34 Q&A, item 32.) The GASB 34 Q&A, items 27 and 80, defines an inexhaustible capital asset as one whose economic benefit or service potential is used up so slowly that its estimated useful life is extraordinarily long and gives the examples of land and certain land improvements and works of art, historical treasures, and similar assets whose useful lives are not diminished by display or educational or research applications. The GASB 34 Q&A, items 35 and 46, states that inexhaustible land improvements may include, for example, excavation, fill, and grading, and exhaustible land improvements may include, for example, parking lots and fences.

7.25 GASB Statement No. 34, paragraph 161, permits governments to use any established depreciation method. Depreciation expense may be calculated for (a) a class of assets, (b) groups of assets of the same class, (c) a network of assets, (d) a subsystem of a network, or (e) individual assets. (See the definitions of networks of assets and subsystems of networks at paragraph 7.19.) In estimating useful life to calculate depreciation expense, a government should consider an asset's present condition and how long it is expected to meet service demands.⁷ Governments also may use composite and group methods to calculate depreciation expense, as described in GASB Statement No. 34, paragraphs 163 through 166. A composite or group depreciation rate should be recalculated if the composition of the assets in the composite or group or their estimated average useful lives change significantly (for example, as assets are acquired or disposed of). The GASB 34 Q&A provides an expanded explanation of composite depreciation methods in items 51 and 52 and nonauthoritative illustrations of their use in exercises 1 and 2 of appendix 4.

7.26 The general standards for the classification of expenses in the government-wide statement of activities are discussed in Chapters 2 and 8, "Expenses/Expenditures and Liabilities." Except for depreciation expense for general infrastructure assets (see paragraph 7.27), depreciation expense should be included as a direct expense of functions in the statement of activities for capital assets that can specifically be identified with a function and for a ratable portion of the depreciation expense for "shared" capital assets (for example, a facility that houses the police department, the building inspection office, and the water utility office). Depreciation expense for capital assets that essentially serve all functions is not required to be included in the direct expenses of the various functions.⁸ That depreciation expense may be included as a separate line in the statement of activities or as part of the general government function (and subsequently may be allocated to other functions as discussed in Chapter 8). If a government uses a separate line in the statement of activities to report unallocated depreciation expense, it should clearly indicate on the face of the statement (for example, through the labeling of the line item) that it excludes direct depreciation expenses of the various programs.

⁷ The GASB 34 Q&A provides additional guidance on calculating estimated useful lives. For example, the GASB 34 Q&A, item 47, states that in determining an asset's estimated useful life, the government also should consider how the asset is used, its construction type, the maintenance policy, and how long it is expected to meet technology demands. In addition, the GASB 34 Q&A, item 48, states that schedules of depreciable lives established by federal or state tax regulations generally are not intended to represent useful lives.

⁸ Determining the point at which an asset serves "essentially all" functions involves professional judgment. The GASB 34 Q&A, item 107, states that an asset that serves "essentially all" functions may be one that serves "many" functions, thus decreasing the ease, practicality, and usefulness of allocating depreciation among functions.

7.27 Depreciation expense for general infrastructure assets should not be allocated to the various functions. Instead, it should be reported as (a) a direct expense of the function (such as, public works or transportation) that the government normally associates with capital outlays for, and maintenance of, infrastructure assets or (b) a separate line item.

Accounting and Financial Statement Presentation— Governmental Funds

7.28 The governmental funds report the costs associated with acquiring general capital assets as expenditures. (Chapter 8 discusses the classification of expenditures in the governmental funds statement of revenues, expenditures, and changes in fund balances.) General capital assets are not capitalized or depreciated in the governmental fund financial statements. However, subject to the government's capitalization policies, general capital assets are recorded in the government's accounting records so that they can be reported in the government-wide financial statements. (See the requirements for capitalizing capital assets in the government-wide financial statement in paragraph 7.13.)

7.29 Because of the current financial resources measurement focus, GASB standards do not require governments to report general capital assets acquired through donation as revenues (or other financial resource inflows) or expenditures in the governmental funds.⁹

Accounting and Financial Statement Presentation— Proprietary Funds

7.30 General accounting standards for proprietary fund capital assets, including infrastructure assets, are the same as those described for the government-wide financial statements in paragraphs 7.13 through 7.19 and 7.23 through 7.25. GASB standards do not establish specific display requirements relating to proprietary fund capital assets. (The provisions discussed in paragraphs 7.21 and 7.22 concerning retroactive application of standards for general infrastructure assets do not apply to infrastructure assets associated with proprietary funds.)

Accounting and Financial Statement Presentation— Fiduciary Funds

7.31 General accounting standards for fiduciary fund capital assets, including infrastructure assets, are the same as those described for the government-wide financial statements in paragraphs 7.13 through 7.19 and 7.23 through 7.25. GASB standards do not establish specific display requirements relating to fiduciary fund capital assets. (The provisions discussed in paragraphs 7.21 and 7.22 concerning retroactive application of standards for general infrastructure assets do not apply to infrastructure assets associated with fiduciary funds.) Certain fiduciary operations, such as PERS, may own land and buildings as investments, not as capital assets used in operations. PERS account for

⁹ The GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements*, item 170, states that, in governmental funds, donated capital assets that are held for use are not recorded in the fund as an asset or revenue. GASB standards do not address the accounting for donated capital assets that are not held for use.

those assets using the standards for investments as indicated in the GASB staff *Guide to Implementation of GASB Statements 25, 26, and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers*, item 71. (See the accounting and financial reporting for investments in Chapter 5, “Cash, Investments, and Investment-related Activity.”)

Capital Leases

7.32 Many governments enter into lease purchase agreements, installment purchase contracts, or other forms of capital asset financing agreements (collectively termed *lease agreements*). The accounting and financial reporting for lease agreements is described in NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, as amended by GASB Statements No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, and No. 14, *The Financial Reporting Entity*. NCGA Statement 5, as amended, provides that the requirements of FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, are the guidelines for accounting and financial reporting for lease agreements, except for operating leases with scheduled rent increases. FASB Statement No. 13, as amended and interpreted, requires that leases that transfer substantially all of the rights and benefits of ownership to the lessee (and that meet specific criteria) be accounted for as an acquisition of an asset and the incurrence of an obligation by the lessee. All other leases should be accounted for as operating leases. Accordingly, a lease is classified as either a capital lease or an operating lease. This chapter discusses lessee accounting and financial reporting for capital leases; Chapter 8 discusses lessee accounting and financial reporting for operating leases. Chapter 12, “Issues Associated with Certain Types of Governments,” in the section on financing authorities, discusses specialized standards for leases between a primary government and a component unit. (Chapter 6 discusses lessor accounting.)

7.33 If a lease agreement is a capital lease following the criteria of FASB Statement No. 13, as amended and interpreted, the agreement generally should be capitalized. Capital lease accounting in the government-wide, proprietary fund, and fiduciary fund financial statements should follow FASB Statement No. 13, as amended and interpreted, without modification. Generally, the amount capitalized, as determined at the beginning of the term of the lease, is the lesser of the present value of the rental and other minimum lease payments or the fair value of the leased property, excluding actual or estimated payments for executory costs to be paid by the lessor, together with any profit thereon. The leased property is amortized in accordance with the government’s normal depreciation policy for owned assets of the same type. The amortization period is restricted to the lease term, rather than the useful life of the asset, unless the lease provides for transfer of title or includes a bargain purchase option. FASB Statement No. 13, as amended and interpreted, contains additional details concerning lessee accounting for capital leases.

7.34 NCGA Statement 5, as amended, states that capital leases are reported differently in the governmental funds than in the other basic financial statements. Reporting is different because of the current financial resources measurement focus and modified accrual basis of accounting used in the governmental funds. The aggregate purchase liability should be reported as an expenditure and an other financing source in the governmental fund that acquired or constructed the general capital asset. (General capital assets and general long-term liabilities arising from governmental fund capital leases

should be reported only in the governmental activities column in the government-wide statement of net assets.) NCGA Statement 5, as amended, requires payments under the lease agreement to be recorded in the same manner as other debt service payments. (Chapter 8 discusses the recognition of expenditures for debt service payments.)

7.35 Some lease agreements may contain a fiscal funding or cancellation clause to avoid classification as legal debt for debt limit or voter referendum purposes. Such a clause provides that, although the government will use its best effort to make the lease payments, it may terminate the lease without penalty if its appropriating body does not allocate the necessary moneys for lease payments in future adopted budgets. That clause gives the financing the character of a one-year annually renewable lease and is not considered legal debt by a number of governments under their state laws. However, NCGA Statement 5, paragraph 20, indicates that the potential for cancellation of most government lease agreements is remote, and paragraph 21 states that fiscal funding or cancellation clauses should not prohibit lease agreements from being capitalized. Therefore, if a lease agreement meets all other capitalization criteria except for the noncancelable criterion, the likelihood of the lease being canceled must be evaluated. If the possibility of cancellation is remote, the lease should be capitalized by recording the leased asset and the lease obligation (liability).

Modified Approach for Infrastructure Assets

7.36 GASB Statement No. 34 introduces an alternative to the depreciation of infrastructure assets that are part of a network or subsystem of a network (eligible infrastructure assets) that it terms the *modified approach*. Because the modified approach is an alternative to depreciation, it can be used for eligible infrastructure assets in the government-wide and proprietary and fiduciary fund financial statements. The modified approach is not used in the governmental fund financial statements because those financial statements do not record capital assets or depreciation. The modified approach may not be applied to an individual infrastructure asset unless that asset constitutes an entire network or subsystem, such as a dam or a levee. It also may not be applied to non-infrastructure capital assets. (As indicated in paragraph 7.01, buildings, except those that are an ancillary part of a network of infrastructure assets, are not considered infrastructure assets.)

7.37 Governments that meet two requirements as discussed in paragraphs 7.38 and 7.39 can elect to use the modified approach for eligible infrastructure assets in lieu of the depreciation method. If a government applies the modified approach to a network of infrastructure assets, the two qualifying requirements have to be met for that network. If a government applies the modified approach to a subsystem of infrastructure assets, the two qualifying requirements have to be met for that subsystem.

7.38 The first requirement is for the government to have an asset management system with certain features. The system has to have an up-to-date inventory of the infrastructure assets, and it has to estimate the annual costs to maintain and preserve those assets at the condition level the government has established and disclosed through administrative or executive policy or legislative action. The system also has to assess the condition of the assets periodically, summarizing the results using a measurement scale (for example, by using a condition index or by stating the percentage of the assets that are in good or poor condition). Condition assessments may be performed based on

statistical samples¹⁰ of the assets or on a cyclical basis (for example, one-third of all the assets in the network or subsystem every year for three years.) The condition assessments also have to be documented in such a manner that they can be replicated. Footnote 18 to GASB Statement No. 34, paragraph 23, defines *replicable condition assessments* as those that are based on sufficiently understandable and complete measurement methods such that different measurers using the same methods would reach substantially similar results.

7.39 The second requirement is that the government document that the eligible infrastructure assets are being preserved approximately at (or above) the condition level the government has established and disclosed. Adequate documentary evidence is a matter of professional judgment because governments' asset management systems and condition assessment methods vary (both among governments and within governments for different networks or subsystems). However, a government that uses the modified approach has to document that it has performed a complete condition assessment of the assets at least every three years. If the government uses a cyclical basis to perform condition assessments, a complete condition assessment is one that, over no more than three years, evaluates all (or statistical samples of) the assets in the network or subsystem in a consistent manner. The government also has to document that the results of the three most recent complete condition assessments provide reasonable assurance that the assets are being preserved approximately at (or above) the intended condition level. GASB Statement No. 34 does not establish standards for expressing the condition levels of infrastructure assets accounted for using the modified approach.

7.40 GASB Statement No. 34, paragraph 25, provides that with the modified approach, expenditures for additions and improvements to eligible infrastructure assets (which increase the capacity or efficiency of assets rather than preserve their useful lives) are capitalized. All other expenditures, including preservation costs, are expensed in the period incurred.

7.41 GASB Statement No. 34, paragraph 152, permits a government to begin to use the modified approach as long as at least one complete condition assessment is available and it documents that the assets are being preserved approximately at (or above) the intended condition level. GASB Statement No. 34, paragraph 25, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, paragraph 8, provides that a change to the modified approach should be accounted for as a change in accounting estimate, meaning that depreciation is no longer recorded on the assets and the assets remain recorded at book value (original cost less accumulated depreciation) at the time of the modified approach is adopted. The original cost, which may include capitalized preservation costs, is not restated.

7.42 If a government no longer meets the requirements for using the modified approach or chooses to change from the modified approach to the depreciation method, the assets should be depreciated beginning with the next reporting period. Footnote 21 to GASB Statement No. 34, paragraph 26, states that the change to depreciate the assets should be reported as a change in accounting estimate, meaning that depreciation is applied only prospectively, not retroactively calculated.

¹⁰ GASB Statement No. 34 does not permit the use of haphazard or judgmental samples.

7.43 Governments that use the modified approach for eligible infrastructure assets are required to present the following two schedules as required supplemental information (RSI) to allow users to analyze the extent to which there is ongoing preservation of those assets:¹¹

- a. For at least the three most recent complete condition assessments, the assessed condition of the assets, showing the dates of the assessments
- b. For the past five reporting periods, the annual estimate at the beginning of each fiscal year of the amount to maintain and preserve the assets at (or above) the condition level established and disclosed by the government, compared with the amounts actually expensed¹²

The information in the RSI schedules should be for the networks or subsystems for which the modified approach is used, and should be derived from the entity's asset management system described in paragraph 7.38.

7.44 GASB Statement No. 34, paragraph 133, requires certain disclosures to accompany the two schedules discussed in paragraph 7.43. Those disclosures are:

- a. The basis for the condition measurement and the measurement scale used to assess and report condition
- b. The intended condition level for preserving the assets
- c. Factors that significantly affect trends in the reported information, such as changes in the measurement basis and scale and the intended condition level. If there is a change in intended condition level, the government also should disclose an estimate of the effect of that change on the current-year estimate of maintenance and preservation costs

Interfund Movements of Capital Assets

7.45 A government may move capital assets from one proprietary or fiduciary fund to another. It also may move general capital assets to a proprietary or fiduciary fund (or visa versa). (There also may be a movement of related debt at the same time.) These capital asset movements are accounted for at the asset's book value (original cost less accumulated depreciation, if any) at the time of the movement. Consequently, no gain or loss is recognized in a proprietary or fiduciary fund from which the asset is moved. Further, because general capital assets are not capitalized in governmental funds, there is no accounting effect in those funds for movements of general capital assets. The government-wide financial statements should report internal activity for such movements between the governmental and business-type activities. The asset's book value should be moved from one column to the other and equal, offsetting internal activity should be reported and then eliminated in the total primary government column.

¹¹ The limited procedures and auditor's reporting for required supplementary information (RSI) are discussed in Chapters 4, "Planning the Audit," and 14, "Audit Reporting." Presenting RSI for discretely presented component units is a matter of professional judgment, as discussed in Chapter 3, "The Financial Reporting Entity."

¹² If the three most recent complete condition assessments and the estimated and actual amounts to maintain and preserve the infrastructure assets for the previous five reporting periods are not available initially, GASB Statement No. 34, paragraph 153, allows the information presented in the schedules to be presented for as many complete condition assessments and years of estimated and actual expenses as are available.

7.46 If, for example, a government moves a general capital asset to a proprietary fund, there should be a “one-sided” entry in the funds for the movement; that is, only the proprietary fund should report the movement. The 2nd GASB 34 Q&A, item 101, states that the proprietary fund would classify the movement as a capital contribution (in the last section of the statement of revenues, expenses, and changes in net assets). It also states that both sides of the movement should be reported in the government-wide statement of activities as a transfer from governmental activities to business-type activities. The fact that the movement affects government-wide activities but not the governmental funds should be reported as a reconciling item between the governmental fund and government-wide financial statements. (See the discussion of financial statement reconciliations in Chapter 10, “Equity and Financial Statement Reconciliations.”)

Capital Assets Used in Landfills

7.47 GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, establishes specialized accounting and financial reporting standards for equipment and facilities relating to municipal solid waste landfills. See that Statement as well as the discussion of closure and postclosure care liabilities in Chapter 8.

Disclosures¹³

7.48 GASB Statement No. 34, paragraphs 116 and 117, requires governments to provide details in the notes to the financial statements about the primary government's capital assets reported in the government-wide statement of net assets. The information in the disclosure should be divided into major classes of capital assets as well as between type of activity (governmental versus business-type). Capital assets that are not being depreciated should be disclosed separately from those that are being depreciated. Information by major classes of capital assets should include beginning- and end-of-year balances (with accumulated depreciation presented separately from historical cost), capital acquisitions, sales or other dispositions, and current-period depreciation expense. The amount charged to each function in the statement of activities also should be disclosed. These disclosures should include capitalized collections of works of art, historical treasures, and similar assets. For collections that are not capitalized, GASB Statement No. 34, paragraph 118, requires the government to disclose a description of the collection and the reasons those assets are not capitalized.

7.49 The following are among the other disclosures required for capital assets:

- The policy for capitalizing assets and for estimating the useful lives of those assets that are used to calculate depreciation expense (GASB Statement No. 34, paragraph 115) (Item 116 in the 2nd GASB 34 Q&A indicates that disclosures about capital asset policies may include [a] the capitalization threshold,¹⁴ [b] the methods used for estimating

¹³ Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in Chapter 3.

¹⁴ Item 30 in the GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A) discusses how a government's capitalization policy may include differing capitalization thresholds for different types of capital assets.

historical cost or fair value, and [c] and the extent of infrastructure capitalization. Those disclosures also could include the basis for valuing capital assets, including the capitalization of interest and ancillary charges.)

- A general description of the method or methods used to compute depreciation with respect to major classes of depreciable assets, as required by APB Opinion No. 12, *Omnibus Opinion—1967*, paragraph 5¹⁵
- If using the modified approach for reporting eligible infrastructure assets, a description of that approach (GASB Statement No. 34, paragraph 115)
- Pertinent data regarding capital leases (FASB Statement No. 13, as amended and interpreted, as required by NCGA Statement 5, paragraph 27)
- Construction commitments (NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 158, and NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4)

Management's Discussion and Analysis

7.50 GASB Statement No. 34 requires the presentation of a management's discussion and analysis (MD&A) as discussed in Chapter 2. Two of the requirements for presentation in MD&A, which is RSI,¹⁶ involve capital assets. Those items are:

- Significant capital asset activity during the year, including a discussion of commitments made for capital expenditures. (As an alternative, governments may summarize the information in the disclosures discussed in paragraph 7.48 and refer to it for additional details)
- For governments that use the modified approach to report eligible infrastructure assets, (a) significant changes in the assessed condition of eligible infrastructure assets from previous condition assessments, (b) how the current assessed condition compares with the condition level the government has established, and (c) significant differences between the actual amounts spent during the current year to maintain and preserve eligible infrastructure assets and the estimated annual amount

7.51 As discussed in Chapter 2, MD&A also should include a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations. Examples of currently known facts, decisions, or conditions related to capital assets that might be expected to have a significant effect on financial position or results of operations could be: the award and acceptance of a major capital grant; a successful bond referendum for capital improvement or construction; the failure of a referendum to renew a property tax millage dedicated for capital improvement; a vote by the governing board to significantly change the condition

¹⁵ See the discussion of the applicability of private-sector standards to governmental financial statements in Chapter 2, "Financial Reporting." APB Opinion No. 12, *Omnibus Opinion—1967*, paragraph 5, which applies to the government-wide and proprietary fund financial statements, permits this required information to be disclosed either in the financial statements or in the notes thereto. In addition, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 5, states that disclosure in the notes to the financial statements is needed only when the information required to be disclosed is not displayed on the face of the financial statements.

¹⁶ See footnote 11.

level the government will use in the future to preserve and maintain infrastructure assets accounted for using the modified approach; and the finalization of contracts to rebuild a school heavily damaged by a fire.

Auditing Considerations¹⁷

7.52 The audit objectives for capital assets and related accounts, categorized by financial statement assertion, are as follows:

- *Existence or Occurrence.* Recorded capital assets exist as of year end. Capital expenditures and depreciation expense represent a valid listing of all such amounts relating to the period.
- *Completeness.* Recorded capital assets include all items owned or otherwise required to be reported by the entity (such as capital assets acquired through capital leases), considering the entity's capitalization policies, and accumulated depreciation includes all appropriate amounts relating to the depreciation of those assets. Capital expenditures and depreciation expense represent a complete listing of all such amounts relating to the period.
- *Rights and Obligations.* Recorded capital assets represent a valid listing of the capital assets owned or otherwise required to be reported by the entity. Capitalized costs and related accumulated depreciation associated with all capital assets no longer owned or otherwise required to be reported by the entity have been removed from the accounting records. Capital asset transactions are made in accordance with legal and contractual provisions that have a direct and material effect on the determination of financial statement amounts.
- *Valuation or Allocation.* Capital assets are stated at actual or estimated cost or fair value on the date of donation, those amounts appropriately include capitalized interest (for proprietary fund assets) and ancillary charges, and the capitalization threshold policies are reasonable. Recorded accumulated depreciation represents a valid accumulation of amounts depreciated through year-end. Depreciation expense represents an allocation of the net cost of all depreciable capital assets over their estimated useful lives in a systematic and rational manner. Capital assets are transferred between funds at net book value net of related debt (if applicable). For eligible infrastructure assets accounted for using the modified approach, (a) capitalized amounts represent only original cost plus additions or improvements, and there is no accumulated depreciation recorded for those assets, (b) the asset management systems used by the government to manage the assets have the characteristics specified in GASB Statement No. 34, and (c) the assets' condition levels are approximately at or above the level established by the government.
- *Presentation and Disclosure.* Leases of capital assets are properly classified as capital or operating. Capital assets transferred between funds are appropriately reported. Capital assets, accumulated depreciation, capital expenditures, and depreciation expense are properly classified in the financial statements, and related disclosures are made in conformity with generally accepted accounting principles (GAAP), consistently applied.

¹⁷ Chapter 8, "Expenses/Expenditures and Liabilities," also discusses internal control features and auditing procedures applicable to capital asset acquisitions.

7.53 The auditor needs to determine that adequate procedures are performed related to each of those opinion units with material capital asset activity and balances. (See the discussion of opinion units in Chapter 4.) The auditor should obtain an understanding of the government's internal control over capital assets and related accounts. In addition to standard internal control features for those assets and accounts, features that are unique or significant in government may include policies and procedures that will:

- Ensure that capital asset acquisitions and dispositions are initiated and administered in accordance with budgetary and other legal and contractual provisions
- Define and identify the infrastructure assets that are owned or otherwise required to be reported by the government
- Ensure the proper calculation and recording of depreciation expense, including functional allocations
- Properly record any transfers of capital assets and related debt between funds
- Ensure that the asset management system and the documentation of the condition of the assets comply with the standards in GASB Statement No. 34, if eligible infrastructure assets are accounted for using the modified approach
- Ensure that all appropriate GAAP-required disclosures are made in the financial statements

7.54 In addition to standard audit procedures for capital assets and related accounts and in addition to the audit considerations and procedures discussed in paragraphs 7.55 through 7.68, procedures relating to those assets and accounts that are unique or significant in government may include the following:

- Reviewing underlying documentation (such as statutes and regulations, governing board minutes, grant contracts and donor letters, and contracts to lease or sell capital assets) and interviewing the entity's management to determine legal and contractual provisions relating to capital assets and related accounts that could have a direct and material effect on the determination of financial statement amounts
- Comparing the entity's budgeted and actual capital outlays for the period and investigating significant variances.
- Determining whether the entity has satisfactory title to capital assets or other evidence supporting the reporting of infrastructure assets (see also paragraph 7.58), whether any liens exist, or whether any capital assets have been pledged
- Evaluating whether depreciation expense is properly charged to the various functions
- Evaluating whether transfers of capital assets and related debt between funds have been properly reported
- If eligible infrastructure assets are accounted for using the modified approach, determining that the asset management system and the documentation of the condition of the assets comply with the standards in GASB Statement No. 34 (See the further discussion in paragraphs 7.60 through 7.68.)
- Evaluating whether financial statement disclosures for capital assets and related accounts are in conformity with GAAP

Capital Asset Records

7.55 A government's accounting records may not be adequate to provide evidential matter to support the financial statement assertions for capital asset accounts. Some entities have not maintained or reconstructed detailed records of their capital assets, especially older assets. Without detailed records, it may be particularly difficult for the entity to provide persuasive support for calculating depreciation expense, recording and reporting capital asset dispositions, and allocating depreciation expense among functions. The auditor should use professional judgment in evaluating whether and to what extent the lack of detailed capital assets records affects the report on the financial statements. Factors that the auditor might consider include the relative significance of those capital assets for which detailed records do not exist compared to those for which they do, the existence of other evidential matter to support the applicable financial statement assertions, and the materiality of the capital assets and related accounts to the opinion unit reporting those accounts. The auditor also should consider whether the lack of records constitutes a reportable condition in internal control (including whether it constitutes a material weakness) that should be communicated to the audit committee or others (such as the governing body) in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended by SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). Even if the auditor determines that the lack of detailed records does not represent a reportable condition, the auditor may choose to communicate the matter for the benefit of management or others, as appropriate.

7.56 GASB Statement No. 34 requires certain disclosures about capital assets to be divided into major classes of capital assets; it also provides that certain assets are inexhaustible or may be accounted for using the modified approach and thus not subject to depreciation. If a government has not separately identified its major classes of capital assets or nondepreciable capital assets in its capital asset records, it either cannot conform with or provide support of its conformity with those GAAP requirements. The auditor's considerations in that situation are the same as for the lack of detailed records for capital asset, as discussed in paragraph 7.55.

7.57 Governments may reconstruct, expand, or refine their capital asset records to provide the information needed to conform with GAAP. Reconstruction of those records may be based on actual historical data or on estimation procedures. In the period that a government reconstructs or expands its capital asset records, the auditor should consider performing procedures normally applied to capital asset additions to all new information in the records (even though the entries represent previously owned assets). If the government uses a specialist to assist in the reconstruction of its capital assets records, the auditor should refer to the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, AU sec. 336). The auditor should consider recommending that the government retain a permanent record of the matters addressed during the reconstruction or expansion of its capital asset records to provide ongoing support for the amounts in future periods. The auditor also should consider documenting the procedures performed and the result as a permanent record in the audit documentation (perhaps through a summary memo).

Ownership of Infrastructure Assets

7.58 The auditor should consider reviewing title documents, plat maps, capital grant agreements, accounting records for maintenance and repair costs,

board minutes, engineering department logs, and maintenance department work orders to ascertain the auditee's ownership of or (if ownership is unclear) responsibility for managing infrastructure assets. The auditor also should consider making inquiries of management and the entity's legal counsel and obtaining written management representations that address the ownership or management of infrastructure assets to provide corroborating evidence for the reporting of infrastructure assets.

Useful Lives of Infrastructure Assets

7.59 To depreciate infrastructure assets, a government needs to, among other things, estimate the assets' useful lives. It may be difficult to establish estimated useful lives for infrastructure assets with reasonable certainty because, by definition, they normally can be preserved for a significantly greater number of years than other capital assets. The auditor should consider determining that the entity has evaluated appropriate factors in establishing those lives. Sources of information about estimated useful lives of infrastructure assets include engineering professionals, appropriate federal agencies and industry associations (such as the U.S. Federal Highway Administration and the American Public Works Association), and other governments in close proximity with similar infrastructure assets. Useful lives that are based on arbitrary measures, such as the length of the term of bonds used to finance the assets, may not appropriately represent the assets' estimated useful lives. In evaluating an entity's estimate of useful lives for infrastructure assets, the auditor also could consider whether the entity has evaluated the other factors discussed in paragraph 7.25 and footnote 7.

Modified Approach for Infrastructure Assets

Costs that Extend Initial Estimated Useful Lives

7.60 Usually, after a capital asset is placed into service, expenditures that extend its initial estimated life are capitalized. However, under the modified approach, that is not the case. As discussed in paragraph 7.40, only expenditures that increase the original capacity or efficiency of those assets are capitalized. The auditor should consider this nuance in evaluating the entity's capitalization policy relating to infrastructure assets accounted for using the modified approach.

Condition Assessments

7.61 To use the modified approach, GASB Statement No. 34, paragraph 24, requires the government to document that the three most recent complete condition assessments provide reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the condition level established and disclosed by the government.¹⁸ There are two interrelated matters involved in determining whether a government has met that requirement. One has to do with whether and to what extent the three individual condition assessments could be below the established condition level. (See paragraph 7.62.) The other has to do with whether a single substandard condition assessment constitutes a breach of the requirement. (See paragraph 7.63.)

¹⁸ GASB Statement No. 34 permits governments to begin to use the modified approach with only one complete condition assessment. See paragraph 7.41.

7.62 The standard's use of the term *approximately* allows flexibility. The actual condition levels do not have to equal or exceed the condition level established by the government; a reasonable variance below the established level is permissible. The auditor could view "reasonableness" in this context in different ways, for example:

- The percentage variance between the actual and established condition levels (For example, an actual level of 72 would vary from an established level of 75 by four percent; that is, 72 is 96 percent of 75.)
- The relative cost, size, or other measure of assets in the network or subsystem that fail to meet the established condition level compared to the total cost, size, or other measure of all of the assets in the network or subsystem.

7.63 GASB Statement No. 34 does not specify that a single substandard condition assessment constitutes a breach of the requirement. If that had been the intent, the use of the modified approach would have been conditioned on *each* complete condition assessment providing reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the established condition level. The requirement to consider the results of the *three* most recent condition assessments requires the preparer and auditor to take a broader perspective to the evaluation and consider the three condition assessments together as a whole. One approach would be to consider the trend of the three most recent condition assessments; an upward trend would be more "reasonable" than a downward trend. However, the nature and circumstances surrounding a single substandard condition assessment might lead to a conclusion that the three most recent condition assessments, taken as a whole, do not provide the stipulated reasonable assurance. The auditor should exercise professional judgment in evaluating whether a single substandard condition assessment taken together with the two other assessments provide reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the established condition level.

7.64 An auditor cannot evaluate the results of a condition assessment until it is complete, which GASB Statement No. 34 permits to take up to three years. GASB Statement No. 34 also does not require that condition assessment activities be conducted every year; it only requires that a complete condition assessment be conducted at least every three years. Therefore, an entity may disclose in its summary of significant accounting policies that it uses the modified approach to account for eligible infrastructure assets even though there has been no condition assessment activity during the period. When this occurs, the auditor should consider obtaining in the management representation letter a specific representation of the entity's intent to use the modified approach. To substantiate that intent, the auditor could, for example, review minutes of governing board meetings, compare the year's actual maintenance/preservation costs to the estimated amount, and discuss the plans for future condition assessment activity with the staff that perform the assessments. If the entity does not represent that it intends to continue to use the modified approach (for example, if it represents that it intends to change to the depreciation method before the next complete condition assessment is required), the auditor should consider whether that intention affects the carrying value of the assets, is adequately disclosed in the financial statements, and affects the auditor's report on the financial statements.

7.65 GASB Statement No. 34 requires condition assessments to be documented in such a manner that they can be replicated. (See paragraph 7.38.) Determining whether a condition assessment is replicable does not require the

auditor to reperform all or part of the condition assessment, although such a procedure could be used. Instead, in evaluating whether condition assessments are replicable, the auditor could consider, for example, internal control over the input and output of information and the extent to which the procedures needed to use the method are documented. If a condition assessment is found not to be replicable and the entity continues to apply the modified approach in the subsequent reporting period, that constitutes a departure from GAAP, not a scope limitation.

7.66 Management may engage a specialist to develop the condition assessment method or to perform the condition assessments.¹⁹ Further, the auditor may engage a specialist to evaluate whether a condition assessment is replicable. In those situations, the auditor should refer to the guidance in SAS No. 73. If a government uses another organization to perform its condition assessments and those services are part of the government's information system, that other organization meets the definition of a service organization. SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance to the auditor about the situations and ways in which to consider the effect of the service organization's controls on user organization's controls. Also see the AICPA Audit Guide *Service Organizations, Applying SAS No. 70, as Amended* for clarification regarding the guidance in SAS No. 70, as amended.

7.67 Footnote 18 to GASB Statement No. 34, paragraph 23, permits condition assessments to be performed by the government itself or by contract. The GASB 34 Q&A, item 68, states that there are no minimum training requirements for staff that manage an asset management system. However, the level of expertise and experience of the persons conducting the assessments is an element of internal control over the inputs and outputs of the information. Therefore, in evaluating that internal control, the auditor should consider evaluating the qualifications of the individuals who perform the condition assessments, including their educational background, experience in performing condition assessments (especially with the types of infrastructure assets for which they are currently performing condition assessments), and the nature and level of training on consistently applying the measurement method.

7.68 The auditor also should consider evaluating whether complete condition assessments have been performed in a consistent manner, as required by GASB Statement No. 34, paragraph 24. The GASB 34 Q&A, item 255, states that consistency is achieved if the entire condition assessment is performed using the same condition assessment method, basis for the condition measurement, and measurement scale. A government may change the method, basis, or scale before beginning the subsequent complete assessment. For example, if a government performs its condition assessment over a three-year cycle, and changes the method, basis, or scale during the third year of the cycle, it would have to perform a condition assessment on all (or a statistical sample) of the subject assets during that third year using the new method, basis, or scale. Alternatively, the government could complete the cyclical condition assessment using the old method, basis, or scale, and make the change at the beginning of the next assessment cycle. If changes are made in the method,

¹⁹ A government's use of a specialist does not eliminate or minimize the asset management system or documentation requirements for using the modified approach discussed in paragraphs 7.37 through 7.39. If a specialist is used, the government will need to either maintain the documentation or be able to access or obtain it from the specialist, even if the specialist uses a proprietary product.

basis, or scale used during the periods covered by the RSI schedules, the limited procedures required for RSI (as discussed in Chapter 4) should alert the auditor to whether those changes are appropriately disclosed as described in paragraph 7.44.

Transition to GASB Statement No. 34

7.69 GASB Statement No. 34 makes several significant changes in the accounting for capital assets:

- It discontinues the reporting of general fixed assets in the fund-based financial statements. Accordingly, there is no longer a general fixed assets account group. General fixed assets, renamed *general capital assets*, are reported only in the governmental activities column of the government-wide financial statements. However, expenditures to acquire general capital assets continue to be reported in the governmental funds.
- It requires all general capital assets to be capitalized in the government-wide financial statements, except for certain general infrastructure assets as discussed in paragraphs 7.21 and 7.22 and certain works of art, historical treasures, and similar assets as discussed in paragraph 7.23. This capitalization requirement applies to general infrastructure assets, which many governments previously did not capitalize.
- As discussed in paragraph 7.24, it requires the net cost of all capital assets to be depreciated, unless the assets are inexhaustible, infrastructure assets accounted for using the modified approach, or construction in progress. The modified approach is a new methodology that permits governments not to depreciate infrastructure assets under certain conditions, as discussed in paragraphs 7.36 through 7.44.

7.70 The auditor should consider recommending that the government retain a permanent record of the implementation of the GASB Statement No. 34 capital asset standards. That is because conditions existing before the implementation of GASB Statement No. 34 and choices made during implementation will affect whether capital assets are properly stated in conformity with GAAP in future periods. For example, as discussed in paragraph 7.23, collections of works of art, historical treasures, and similar assets already capitalized at June 30, 1999, are required to remain capitalized and all additions to those collections are required to be capitalized, even if they meet the conditions for exemption from capitalization. Therefore, it is advisable for the government to consider documenting as a permanent record whether the collections owned on June 30, 1999, were or were not capitalized as of that date. The auditor also should consider documenting the implementation of the GASB Statement No. 34 capital asset standards in a summary fashion as a permanent record in the audit documentation.

7.71 GASB Statement No. 34 includes several provisions to minimize the burden of retroactively applying the capitalization requirement to general infrastructure assets.²⁰ Those provisions include (a) exempting phase 3 governments²¹ from the requirement, (b) allowing phase 1 and 2 governments

²⁰ The provisions that limit retroactive application do not apply to infrastructure assets associated with proprietary and fiduciary funds because of previous requirements for reporting infrastructure assets in those funds. See also paragraph 7.80.

²¹ GASB Statement No. 34 is applicable in three phases based on an entity's revenues or similar resource inflows. See the transition section in Chapter 2.

additional time to retroactively apply the capitalization requirement, (c) allowing governments to estimate historical cost for existing major general infrastructure assets if actual historical cost data are not available, and (d) requiring that phase 1 and 2 governments retroactively apply the capitalization requirement to only *major* general infrastructure assets (defined in paragraph 7.22) acquired or significantly reconstructed, or that received significant improvements, in fiscal years ending after June 30, 1980. However, some governments may not want to limit their retroactive application of the general infrastructure asset capitalization requirement because they have outstanding debt relating to general capital assets and want to report assets to offset the effect of that debt in the “invested in capital assets, net of related debt” component of net assets in the government-wide financial statements.

7.72 For phase 3 governments, retroactive application of the capitalization requirement to major general infrastructure assets is encouraged, but not required. Other governments are required to retroactively apply the requirements to major general infrastructure assets within at least four years of the adoption of the GASB Statement No. 34, specifically:

- Phase 1 governments are required to retroactively apply the capitalization requirement to all major general infrastructure assets by no later than fiscal years beginning after June 15, 2005.
- Phase 2 governments should retroactively apply the capitalization requirement to all major general infrastructure assets by no later than fiscal years beginning after June 15, 2006.

Despite the provisions waiving or delaying retroactive application of the capitalization requirement to general infrastructure assets, GASB Statement No. 34 encourages all governments to retroactively apply the requirement to (a) all major general infrastructure assets when it otherwise implements the provisions of the standard and (b) nonmajor networks of general infrastructure assets. It also requires prospective application of the capitalization requirement to general infrastructure assets when the government otherwise implements the provisions of the standard.

7.73 During transition to the provisions of GASB Statement No. 34, governments may partially implement retroactive application of the capitalization requirement to general infrastructure assets. If information is not available for all networks of infrastructure assets, those networks for which information is available may be reported. (A government may not partially implement retroactive application for individual general infrastructure assets or for subsystems of networks.) Also during the transition period, governments are required to disclose descriptions of (a) the infrastructure assets being reported and those that are not and (b) any infrastructure assets that the government has decided to report using the modified approach.

7.74 Historically, many governments have not maintained detailed records to support the financial reporting and depreciation of general capital assets, especially infrastructure assets, required by GASB Statement No. 34. Generally, detailed records will be needed to support that the amounts reported in the financial statements are in conformity with GAAP. (The adequacy of detailed records for general capital assets, which may be an ongoing audit consideration in addition to a transition consideration, is discussed in paragraphs 7.55 through 7.57.) Governments that have to reconstruct, expand, or refine detailed records for a large number of capital assets should allow adequate time for the process. The next two paragraphs discuss certain considerations relating to the auditor’s consideration of that process.

7.75 Although GASB Statement No. 34 requires capital assets to be reported at historical cost, it also specifically permits the use of estimates to retroactively apply the capitalization requirements to general infrastructure assets if determining the actual historical cost is not practical because of inadequate records. It may not be practical to determine actual historical cost because of inadequate records when, for example, (a) original records have been destroyed without being retained on microfilm or other storage medium or (b) records are stored on software that is no longer in use or stored in multiple physical locations or in multiple formats, and using those records to obtain actual historical cost would involve more cost, time, or effort than estimating historical cost. The auditor should consider obtaining evidence concerning the government's reasons why it was not practical to determine actual historical cost, for example, by examining the government's documentation and by interviewing appropriate officials.

7.76 GASB Statement No. 34, paragraphs 158 through 160, provides examples of methods to estimate the historical cost of general infrastructure assets. Those examples include (a) deflating the current replacement cost of a similar asset through the use of price-level indexes to the actual or estimated acquisition year and (b) using historical records, such as bond documents, prior-year expenditures for capital outlay, and engineering documents, to estimate the amounts. Other potential sources are prior-year governing board minutes and reports filed with the grantor agencies that financed the assets. Similarly, if the government has to retroactively reconstruct records for other capital assets, estimates that materially represent actual historical cost may have to be used if determining the actual historical cost is not practical. For that purpose, governments could use the estimating techniques described above for general infrastructure assets or other appropriate estimating techniques.

7.77 As indicated in paragraph 7.71, the retroactive application of GASB Statement No. 34's capitalization requirement to major general infrastructure assets by phase 1 and 2 governments is limited to those acquired or significantly reconstructed, or that received significant improvements, in fiscal years ending after June 30, 1980. GASB Statement No. 34 does not define "significantly reconstructed, or that received significant improvements." Determining significance is a matter of professional judgment by the preparer and auditor.

7.78 As indicated in paragraph 7.22, retroactive application of GASB Statement No. 34's capitalization requirement to major general infrastructure assets is based on the cost or estimated cost of the infrastructure network or subsystem. Therefore, even though some general infrastructure assets will not require capitalization, the government has to estimate the cost of its general infrastructure networks or subsystems to determine whether retroactive application is required. This evaluation can be made using preliminary cost estimates, as discussed in the GASB 34 Q&A, item 284.

7.79 Many governments did not report general capital assets in their financial statements in conformity with GAAP in the first fiscal year ending after June 15, 1999. Although the definition of major general infrastructure assets is based on a percentage of all general capital assets *reported* in the first fiscal year ending after June 15, 1999, the presumption of the standard is that the amounts were reported in conformity with GAAP. Therefore, phase 1 and 2 governments that did not report general capital assets in conformity with GAAP do not qualify to use the provisions of GASB Statement No. 34 that limit the retroactive application of the infrastructure capitalization requirement

unless they estimate the amount of GAAP-basis general capital assets that should have been reported in their financial statements in the first fiscal year ending after June 15, 1999. If prior-period amounts are estimated, auditors should consider performing procedures on those amounts to determine whether they are in conformity with GAAP.

7.80 GASB Statement No. 34, paragraph 67, requires certain activities to be reported in enterprise funds. (See the discussion in Chapter 2.) Accordingly, some governments may be required to report activities in enterprise funds that previously have been reported in governmental funds. Some of those activities, such as water and sewer operations, have infrastructure assets that may not have been capitalized previously. In those situations, the infrastructure assets are not general infrastructure assets and consequently, the GASB Statement No. 34 provisions limiting and delaying the retroactive application of the capitalization requirements to general infrastructure assets do not apply to those assets. All infrastructure assets of those enterprise funds should be capitalized when GASB Statement No. 34 is first implemented.

7.81 As discussed in paragraph 7.41, GASB Statement No. 34 permits governments to begin to use the modified approach with only one complete condition assessment. In addition, GASB Statement No. 34, paragraph 24, requires complete condition assessments of eligible infrastructure assets to be performed at least every three years. Therefore, a government may adopt the modified approach with single condition assessment that it completed up to two years before the year it implements GASB Statement No. 34, or it may complete the condition assessment in the year it implements the Statement. (See items 279 and 280 in the GASB 34 Q&A.) Because GASB Statement No. 34 requires governments to apply its capitalization requirement prospectively to general infrastructure assets and retroactively to other infrastructure assets when it otherwise implements the provisions of the standard, a government will likely have to have established its policies and procedures related to the modified approach at that time, or begin to use the depreciation method for those assets. That is, the extended transition provisions in GASB Statement No. 34 relate only to the capitalization and subsequent accounting for general infrastructure assets existing at the beginning of the period that GASB Statement No. 34 is implemented. However, governments may adopt the modified approach in lieu of depreciation accounting in a later period.

Chapter 8

Expenses/Expenditures and Liabilities

Introduction

8.01 Expenses/expenditures¹ and liabilities are closely related, and many audit procedures satisfy the audit objectives of both types of accounts at the same time. That is, evidence that supports assertions about expenses/expenditures also generally supports assertions about liabilities. This chapter discusses accounting, financial reporting, and auditing considerations relating to various transactions and events that result in expenses/expenditures and liabilities. Chapter 7, “Capital Assets,” discusses accounting, financial reporting, and certain auditing considerations for expenses/expenditures for capital assets.²

Nature of Transactions

8.02 The resource outflows that a particular governmental activity statement reports results from its measurement focus and basis of accounting (MFBA). The government-wide, proprietary fund, and trust fund³ financial statements, which use the economic resources/accrual MFBA, report expenses. The governmental fund financial statements, which use the current financial resources/modified accrual MFBA, report expenditures. The primary differences between expenses and expenditures relate to (a) the acquisition of capital assets versus their use, (b) the issuance and payment of long-term debt, and (c) certain current-period costs for which payment normally is not due until future periods.

8.03 Many resource outflows are reported based primarily on events or transactions that require cash disbursements during the current period or shortly thereafter; examples are payroll, rent, utilities, and capital asset acquisitions. Other resource outflows are reported based primarily on known or estimated future-period cash disbursements; examples are compensated absences, and claims and judgments. Still other resource outflows are reported based on the known or estimated use of items acquired through prior-period cash disbursements and reported as assets or deferred charges; examples are depreciation of capital assets, allocations of prepaid items, and the use of inventory items.

¹ In general, this chapter does not discuss interfund transfers, loans, or reimbursements; see Chapter 9, “Interfund, Internal, and Intra-Entity Activity and Balances,” for those items. The terms *expenses* and *expenditures* are used in a generic manner throughout much of this chapter to refer to the resource outflows from other than interfund transfers that are reported in a government’s activity statements. GASB standards require different classifications of those reported resource outflows in the various activity statements, as discussed later in this chapter.

² Although Chapter 7, “Capital Assets,” discusses accounting, financial reporting, and auditing considerations for the acquisition and use of capital assets, this chapter’s discussions of internal control features and auditing procedures also apply to capital asset acquisitions.

³ This chapter refers to *trust funds* rather than to *fiduciary funds* because a government’s basic financial statements do not include activity statements for agency funds.

8.04 Many governments centralize their purchasing, accounts payable, and cash disbursement activities. Small governments usually have a single system to control the ordering and receipt of goods and services, the accounting for expenses/expenditures and liabilities, and cash payments. Larger governments often have multiple systems to control the ordering and receipt of goods and services (for example, purchasing offices for individual departments), but still may account for expenses/expenditures and liabilities and make cash payments through a single system. Some governments may have separate control systems for grant programs or for autonomous departments or agencies. Some governments also have specialized processes to handle small-dollar purchases, such as the use of petty cash funds or debit cards. Many governments centralize their payroll activities, but multiple systems may exist in certain circumstances. Sometimes, certain of a government's cash payments are made by another entity, such as a financial institution that makes principal and interest payments to individual bondholders.

8.05 Many of a government's expenses/expenditures arise from exchange and exchange-like transactions. However, a government also may have significant amounts of resource outflows arising from nonexchange transactions, such as grants and contributions to other entities and individuals, including pass-through grants that are received from other entities to transfer to or spend on behalf of secondary recipients.

8.06 Activities between the funds of a primary government and between the primary government and its component units also may generate expenses/expenditures and liabilities. Accounting, financial reporting, and auditing considerations for reporting those activities in the financial reporting entity's financial statements are discussed in Chapter 9, "Interfund, Internal, and Intra-entity Activity and Balances." However, the measurement and recognition standards for some of the transactions and other events discussed in this chapter apply to those activities, subject to the provisions concerning interfund, internal, and intra-entity activity and balances of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. For example, paragraph 8.45 discusses the treatment of interfund charges for risk financing activities and paragraph 8.23 discusses employer's accounting for single-employer defined benefit pension plans, which may involve payments between a primary government's funds or from a primary government to a component unit. Although the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, do not apply to activities between the funds of a primary government, they do apply to the recognition and measurement of transactions between a primary government and its component units. However, the provisions of GASB Statement No. 34 for interfund, internal, and intra-entity activity and balances affect how nonexchange transactions between the primary government and its component units are reported when component units are included with the primary government in the reporting entity's financial statements.

8.07 Liabilities also arise from issuing debt. Governments borrow money on a short-term basis either to meet seasonal cash needs or in advance of future long-term borrowing. Governments usually borrow on a long-term basis to finance capital asset acquisitions, but they also borrow for noncapital purposes, such as to provide the initial funding for a risk-retention program, to pay claims and judgments, to finance an accumulated operating deficit, or to advance the cash flows relating to long-term or delinquent receivables.

8.08 The expense/expenditure and liability activities of governments often are subject to various compliance requirements, such as the following:

- The amount of a government's spending for particular funds, functions, departments, or object classes usually is subject to budgetary constraints. (See Chapter 11, "The Budget.") Governments generally control compliance with budgetary spending requirements through the use of an encumbrance system. Encumbrances record formal commitments (usually contracts or purchase orders) to acquire goods or services so that budgetary expenditures do not exceed appropriations.
- State and local laws and regulations, debt agreements (covenants or indentures), and grant agreements often impose requirements for competitive bidding for large-dollar purchases. Those requirements usually are designed to ensure that the government gets the best price for the best goods and services and that all qualified vendors, including small and minority vendors, have an equal opportunity to provide the goods and services. Those requirements also may bar certain vendors from providing goods or services to a government, for example, because of previous problems with procurement contracts.
- Employee arrangements may be affected by state and local laws mandating certain fringe benefits; federal laws and regulations mandating the payment of prevailing wage rates on construction projects; civil service requirements for hiring, promoting, and terminating employees; union contracts establishing wage rates and benefits; budgetary authorizations limiting the number of employees authorized by department or function; federal laws and regulations relating to overtime, compensatory time, and employment taxes; and intergovernmental grants or private contributions that restrict the maximum personal service costs that can be charged to the program.
- Many intergovernmental grants, entitlements, private contributions, and trust agreements require that amounts provided be spent for particular purposes or during a particular period or that the recipient government provide matching funds or raise matching contributions. They also may require that cash be disbursed within a short time after its receipt from the grantor or contributor. Certain awards may permit a government to charge indirect costs to a grant, sometimes based on an approved indirect cost allocation plan or rate. Those requirements may be listed in the award document, the recipient government's application for assistance (for example, as part of the program budget), or in cost circulars or program regulations.
- State and local laws usually impose limits on the amount of debt that a government can issue, and often require approvals by senior levels of government or voters to issue debt. Those limitations can apply to all forms of debt, or they may be structured so there are separate limits and voter requirements for different debt forms (for example, general obligation, revenue, installment, and lease purchase debt) or purposes (for example, debt issued for equipment, water and sewer, or transportation purposes). Local governments may not be able to issue debt without explicit authority in state law, and those laws may limit the form of debt that a local government can issue. Other limitations on the form, type, or amount of debt are imposed by federal tax laws and related Internal Revenue Service (IRS) regulations relating to tax-exempt debt. (See also the discussion in Chapter 5, "Cash, Investments, and Investment-Related Activity," concerning federal arbitrage requirements.)

- Debt agreements require the payment of principal and interest in established amounts and on established dates and limit the use of debt proceeds to specific purposes. Some debt agreements restrict other activities of the issuer. For example, they may require (a) that the fund that will repay the debt maintain certain levels of equity or changes in equity, (b) that particular revenues be used to pay debt service, and (c) certain reserve funds, such as a sinking fund to set aside resources for the future payment of debt service obligations. Debt agreements often require the government to file continuing disclosure documents with certain distributing organizations as discussed in Chapter 16, “Auditor Association with Municipal Securities Filings.”

Although a government should be concerned with all compliance requirements, generally accepted auditing standards (GAAS) focus the auditor’s concern on those compliance requirements that could have a direct and material effect on the determination of financial statement amounts. (See the further discussion of the auditor’s responsibility in this regard in Chapter 4, “Planning the Audit.”)

8.09 Resource outflows are classified in governmental financial statements in various ways. In the government-wide statement of activities, they are reported as expenses (generally classified by function or different identifiable activity) or special or extraordinary items. In the governmental funds, they are reported as expenditures (generally classified by character and function), other financing uses, special items, or extraordinary items. In the proprietary funds, resource outflows are classified as operating expenses, nonoperating expenses, special items, or extraordinary items. The trust funds activity statement classifies resource outflows as “deductions.” See the detailed discussions of the classification of resource outflows in paragraphs 8.83 through 8.90.

Accounting and Financial Reporting Considerations⁴

General Recognition Standards

8.10 The government-wide, proprietary fund, and trust fund financial statements use the economic resources/accrual MFBA. Because of the economic resources measurement focus, those activity statements report expenses, which include the deferral and allocation or amortization of costs that benefit one or more future periods. Because of the accrual basis of accounting, expenses resulting from exchange and exchange-like transactions are recognized when the exchange takes place; expenses from nonexchange transactions are recognized in accordance with GASB Statement No. 33, as explained later in this chapter.

8.11 The governmental funds financial statements use the current financial resources/modified accrual MFBA. Because of the current financial resources measurement focus, governmental funds report expenditures, which generally do not include the deferral and allocation or amortization of costs that benefit one or more future periods.⁵ National Council on Government

⁴ Presenting note disclosures and required supplementary information (RSI) for discretely presented component units is a matter of professional judgment, as discussed in Chapter 3, “The Financial Reporting Entity.”

⁵ See the alternative to use the consumption method for prepaid items and inventory in governmental funds in paragraphs 8.55 and 8.56.

Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 57, as amended, establishes the standards for the modified-accrual recognition of governmental fund expenditures, stating that expenditures should be recognized in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term debt, which should be recognized when due. *Measurable* refers to the ability to reasonably estimate the amount of the expenditure. Other NCGA and GASB pronouncements refine the definition of modified accrual expenditure recognition.⁶

8.12 NCGA Statement 1, paragraph 70, as interpreted, requires that governmental funds accrue liabilities and expenditures in the period in which the government incurs the liability. However, NCGA Statement 1, paragraphs 43 and 44, as amended and interpreted, requires that the portion of general long-term indebtedness that is not matured (due for payment) be reported as general long-term liabilities of the government, rather than as governmental fund liabilities. That requirement applies not only to formal debt issues but also to other forms of general long-term indebtedness. GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, clarifies the modified accrual recognition of expenditures and liabilities.⁷ It states that governmental funds should report matured liabilities and the related expenditures. Matured liabilities include the following:

- *Liabilities that normally are due and payable in full when incurred.* This includes, for example, liabilities for salaries, professional services, supplies, utilities, and travel. In the absence of an explicit requirement to do otherwise, governmental funds should accrue such liabilities (and expenditures) in the period in which the government incurs the liability.
- *The matured portion of general long-term indebtedness.* Debt service on formal debt issues (such as bonds and capital leases) generally should be recognized as a governmental fund liability and expenditure when due (matured)—with optional additional accrual under certain conditions, as discussed in paragraph 8.69. Compensated absences, claims and judgments, special termination benefits, and landfill closure and postclosure care costs should be recognized as governmental fund liabilities and expenditures to the extent the liabilities are “normally expected to be liquidated with expendable available financial resources.” In general, governments are normally expected to liquidate those liabilities with expendable available financial resources to the extent that the liabilities mature (come due for payment) each period. Further, a government may have “other commitments

⁶ Although transactions and other events associated with the governmental funds are reported in the fund financial statements using the current financial resources/modified accrual measurement focus and basis of accounting (MFBA), they are reported in the government-wide financial statements using the economic resources/accrual MFBA, typically as governmental activities. That “conversion” from one MFBA to another is explained in the governmental fund financial statements through the presentation of a summary reconciliation to governmental activities in the government-wide financial statements. See the further discussion of those reconciliations in Chapter 10, “Equity and Financial Statement Reconciliations.”

⁷ The scope of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, does not include operating leases with scheduled rent increases (see paragraph 8.51) or employer contributions to (a) pension plans (see paragraphs 8.23, 8.24, and 8.27) or (b) postemployment healthcare plans if a government elects to measure and recognize its employer contributions in accordance with GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* (see paragraph 8.30).

that are not current liabilities properly recorded in governmental funds,” which are forms of general long-term indebtedness for which explicit recognition criteria have not been established. For such items, a fund liability and expenditure should be recognized when the payments are due.

8.13 The recognition of expenditures and governmental fund liabilities for compensated absences, claims and judgments, special termination benefits, and landfill closure and postclosure care costs is based on the maturity of the liabilities and does not depend on how the government accumulates resources to pay those liabilities. Even though some governments advance-fund part or all of the liabilities covered by the “normally expected” criterion, that advance funding should not result in recognizing additional governmental fund expenditures or liabilities.⁸ Those accumulated net assets should be reported as a part of governmental fund balance—for example, as unreserved, designated fund balance, if appropriate.

8.14 GASB Statement No. 33, paragraph 14, requires that governments report expendable net assets with purpose restrictions as restricted until they use the resources for the specified purpose. The decision whether to first apply unrestricted or restricted resources to specific expenses is a management decision.

8.15 When governments issue long-term debt, the accounting treatment differs depending on the measurement focus used in the financial statements. In the financial statements that use the economic resources measurement focus (government-wide, proprietary fund, and trust fund financial statements), issuing long-term debt results in reporting a liability in the financial position statements, with no effect on the activity statements. In the governmental fund financial statements, however, issuing long-term debt generally results in reporting an other financing source in the activity statement. Issuing short-term debt generally results in reporting a liability in all financial position statements, including the governmental funds balance sheet. See the detailed discussion of debt in paragraphs 8.60 through 8.81.

8.16 Governments should record the issuance of debt in the period debt instruments are issued, that is, on the closing date. No amounts are recorded until the debt instruments are issued. If a closing takes place before year-end but proceeds are not received until early in the following year, receivables and liabilities should be reported on the closing date.

Specific Recognition and Financial Reporting Standards

Employment-Related Transactions and Other Events

Compensated Absences

8.17 GASB Statement No. 16, *Accounting for Compensated Absences*, as interpreted by GASB Interpretation No. 6, provides guidance for measuring liabilities for compensated absences, which are absences for which employees will be paid, such as vacation, sick leave, and sabbatical leave. GASB Statement No. 16 provides different liability measures depending on the characteristics of particular benefits. It also provides alternatives—the termination

⁸ GASB Interpretation No. 6 observes that governments that would prefer accrual-basis recognition of the liabilities covered by the “normally expected” criterion in fund financial statements might consider reporting the activity through a trust or internal service fund.

payment method and the vesting method—for recognizing liabilities for sick leave and other compensated absences with similar characteristics. GASB Statement No. 16 requires (a) the compensated absences liability generally to be measured using the pay or salary rates in effect at the reporting date and (b) additional amounts to be accrued for certain salary-related payments associated with the payment of compensated absences, for example, the employer's share of social security and Medicare taxes and in some cases the employer's contributions to pension plans. The government-wide and proprietary and trust fund financial statements should recognize compensated absences expenses when the liability is incurred. Using the measurement criteria discussed above, governmental funds should recognize compensated absences expenditures and report the related fund liabilities as discussed in paragraphs 8.12 and 8.13.

Internal Revenue Code Section 457 Deferred Compensation Plans

8.18 Governments establish Internal Revenue Code (IRC) Section 457 deferred compensation plans to allow employees to defer part of their pay in a tax-sheltered program. GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*, as amended by GASB Statement No. 34, requires that such a plan that meets the definition of a pension (and other employee benefit) trust fund be reported in that manner. In evaluating whether to report an IRC Section 457 plan as a trust fund, a government should exercise judgment in determining whether it has fiduciary accountability for the plan and whether it holds the assets in a trustee capacity. If the plan is reported, GASB standards provide guidance on the valuation of plan investments. (See Chapter 5.)

Special Termination Benefits

8.19 NCGA Interpretation 8, *Certain Pension Matters*, as amended by GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and as interpreted by GASB Interpretation No. 6, requires governments to apply the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 74, *Accounting for Special Termination Benefits Paid to Employees*.⁹ Consequently, a government that offers special termination benefits to its employees for a short period of time should recognize expenses and liabilities in the government-wide, proprietary funds, and trust funds financial statements when the employees accept the offer and the amount can be reasonably estimated. The amount recognized should include any lump-sum payments and the present value of any expected future payments. The termination of employees under a special termination benefit arrangement may affect the estimated costs of other employee benefits, such as compensated absences, because of differences between past assumptions and actual experience. If reliably measurable, the effects of any such changes on an employer's previously accrued expenses for those other benefits should be included in measuring the termination expense. However, changes in pension benefits that result from special termination

⁹ FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, superseded FASB Statement No. 74, *Accounting for Special Termination Benefits Paid to Employees*. However, the provision in FASB Statement No. 88 superseding FASB Statement No. 74 conflicts with the requirement in NCGA Interpretation 4, *Certain Pension Matters*, to apply FASB Statement No. 74. Therefore, governments should not apply the provisions of FASB Statement No. 88. (See the general discussion in Chapter 2, "Financial Reporting," concerning the application of private-sector pronouncements in governmental financial statements.)

benefits should not be included in measuring termination expense. Using the measurement criteria discussed above, governmental funds should recognize special termination benefit expenditures and report the related fund liabilities as discussed in paragraphs 8.12 and 8.13.

Pensions

8.20 GASB Statement No. 27, as amended by GASB Statement No. 34, establishes accounting and financial reporting standards for pension expenses/expenditures, and related assets and liabilities by governmental employers. The GASB staff document *Guide to Implementation of GASB Statements 25, 26, and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers: Questions and Answers* (GASB 25, 26, and 27 Q&A) provides additional guidance.

8.21 GASB Statement No. 27, as amended, addresses both defined contribution and defined benefit pension plans. (See paragraph 8.27 for a discussion of defined contribution pension plans.) Defined benefit pension plans specify the amount of pension benefits to be provided at a future date or after a certain period of time. Pension benefits include retirement income and all other benefits provided through a defined benefit pension plan, except postemployment healthcare benefits. For example, disability and death benefits provided through a defined benefit pension plan are pension benefits. The same benefits provided through a plan that does not provide retirement income are not pension benefits, rather they are other postemployment benefits. (See paragraphs 8.29 through 8.31.) There are three types of defined benefit pension plans:

- A single-employer plan covers the current and former employees, including beneficiaries, of only one employer. (See also paragraph 8.26.)
- An agent multiple-employer plan is an aggregation of single-employer plans, with pooled administrative and investment functions. Separate actuarial valuations are performed for each employer's plan to determine its periodic contribution rate and other information.
- A cost-sharing multiple-employer plan is a single plan with pooling (cost-sharing) arrangements for the participating employers. All risks, rewards, and costs, including benefit costs, are shared among the participating employers and are not attributed to individual employers. A single actuarial valuation covers all plan members and the same contribution rate applies for each employer.

8.22 GASB Statement No. 27 requires employers that participate in single-employer and agent multiple-employer defined benefit pension plans to measure and disclose an amount for annual pension cost (APC). APC should equal the employer's annual required contributions (ARC) to the plan, unless the employer has a net pension obligation (NPO) for past under- or overcontributions. The ARC is the employer's required contributions for the year, calculated in accordance with certain parameters that concern the frequency and timing of actuarial valuations as well as actuarial methods and assumptions. An NPO is the cumulative difference between APC and the employer's contributions to a plan. An employer with an NPO should measure APC equal to (a) the ARC, (b) one year's interest on the NPO, and (c) an adjustment to the ARC to offset the effect of actuarial amortization of past under- or overcontributions.

8.23 Employers that participate in single-employer and agent multiple-employer plans should recognize annual pension expenses/expenditures, and report related assets and liabilities as follows:

- Pension expense in the government-wide, proprietary fund, and trust fund financial statements should equal the APC as discussed in paragraph 8.22. The NPO should be adjusted for the difference between contributions made and pension expense. A positive (negative) year-end balance in the NPO should be reported as a liability (asset) in the government-wide and fund financial statements. Pension liabilities and assets related to different plans should not be offset in the financial statements. Separate rows and columns should be used to distinguish between assets and liabilities of the total primary government and those of its discretely presented component units, and between assets and liabilities of governmental and business-type activities of the primary government.
- Pension expenditures in the governmental funds should equal the amount contributed to the plan or expected to be liquidated with expendable available financial resources. (Note that the scope of GASB Interpretation 6 does not include employer contributions to pension plans.) The NPO should be adjusted for the difference between pension expenditures and the APC. GASB Statement No. 27, paragraph 16, as amended, provides that a positive year-end balance in the NPO should not be reported in the governmental fund financial statements; it should be reported as a general long-term liability only in the governmental activities column in the government-wide statement of net assets. If the year-end balance in the NPO is negative, a previously reported liability to the same plan should be reduced to zero. Any additional negative amount should be reported as an asset (prepaid expense) in the government-wide financial statements.

8.24 Employers that participate in cost-sharing multiple-employer plans should recognize annual pension expenses/expenditures in all financial statements equal to their contractually required contributions to the plan. Pension liabilities and assets result from the difference between contributions required and contributions made. The GASB 25, 26, and 27 Q&A, item 152, states that when one employer is legally responsible for almost all actuarially determined required contributions to a cost-sharing plan, and that level of responsibility is ongoing and unlikely to change significantly in the foreseeable future, that employer is encouraged to apply the requirements of GASB Statement No. 27 for single-employer plans.

8.25 GASB Statement No. 27, paragraphs 20 and 21, requires various disclosures in the notes to the financial statements for each of a governmental employer's defined benefit pension plans. Those disclosures include, for example, a description of the plan, the funding policy for the plan, and (except for cost-sharing multiple employer plans) information about APC, actual contributions, the NPO, if any, and certain actuarial information. GASB Statement No. 27, paragraph 22, also requires the disclosure of certain multi-year actuarial data as required supplementary information (RSI) by employers that participate in single-employer and agent multiple-employer defined benefit pension plans.¹⁰

8.26 Legal or contractual provisions require some governments to contribute to pension plans that cover the employees of one or more other governments. For example, a state may be legally responsible for the annual "employer" contributions to a pension plan covering school district employees.

¹⁰ The limited procedures and auditor's reporting for required supplementary information (RSI) are discussed in Chapters 4, "Planning the Audit," and 14, "Audit Reporting," respectively.

GASB Statement No. 27, paragraph 28, requires the entity that is legally responsible for the contributions to conform with all its provisions for measurement and recognition of expenses/expenditures, liabilities, assets, note disclosures, and RSI. If the plan is a defined benefit pension plan and the legally responsible entity is the only contributing entity, the requirements of GASB Statement No. 27 for single-employer plans apply, regardless of the number of entities whose employees are covered by the plan.

8.27 Defined contribution pension plans specify how contributions to a plan member's account are to be determined, rather than the amount of retirement income the member is to receive. Employers that participate in defined contribution plans should recognize annual pension expenses/expenditures in all financial statements equal to their required contributions, in accordance with the terms of the plan. Pension liabilities and assets result from the difference between contributions required and contributions made.

8.28 Accounting and financial reporting requirements for pension plans—whether presented in the financial report of a public employee retirement system (PERS) or in the financial report of a plan sponsor or employer—are discussed in Chapter 12.

Other Postemployment Benefits

8.29 GASB Statements No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers*, and No. 27 provide guidance on employer accounting and financial reporting for postemployment benefits other than pension benefits (referred to as “other postemployment benefits” or OPEB). OPEB include postemployment health care benefits (such as illness, dental, vision, and hearing), even if those benefits are provided through a PERS or pension plan. OPEB also includes, for example, life insurance, disability income, tuition assistance, legal services, and other assistance programs unless the benefits are provided through a PERS or pension plan. (See paragraph 8.21.) Employers may or may not advance-fund OPEB by setting aside assets on an actuarially determined or other basis to pay future benefits as they become due.

8.30 GASB Statement No. 12 does not establish standards for measuring and recognizing OPEB expenses/expenditures, and liabilities but requires various disclosures in the notes to the financial statements. (See GASB Statement No. 12, paragraph 10, for those disclosures.) However, employers may elect to apply the provisions of GASB Statement No. 27 to measure and recognize expenses/expenditures and liabilities for postemployment health-care benefits.¹¹ (See paragraphs 8.22 through 8.24.) Further, employers that participate in single-employer or agent multiple-employer postemployment healthcare plans and that use GASB Statement No. 27 to measure and recognize expenses/expenditures and liabilities for those benefits should make the note disclosures required by GASB Statement No. 27, paragraph 24. The GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A) provides additional guidance on the accounting for OPEB.

8.31 Accounting and financial reporting requirements for postemployment healthcare plans administered by a PERS—whether presented in the financial report of a PERS or in the financial report of a plan sponsor or employer—are discussed in Chapter 12.

¹¹ The scope of GASB Interpretation No. 6 does not include employer contributions to post-employment healthcare plans reported using the provisions of GASB Statement No. 27.

Grants, Entitlements, and Shared Revenues, Including Appropriations to Component Units

8.32 Expenses/expenditures for grants, entitlements, and shared revenues, including appropriations from a primary government to a component unit, generally meet the definitions in GASB Statement No. 33 of government-mandated or voluntary nonexchange transactions. Governments should recognize expenses and liabilities for government-mandated and voluntary nonexchange transactions when all applicable eligibility requirements—required characteristics of recipient, time requirements, reimbursements, and contingencies (for voluntary nonexchange transactions)—are met. (Chapter 6, “Revenues and Receivables,” discusses those eligibility requirements.) GASB Statement No. 33, paragraph 11, states that the standards in the Statement apply whether the accrual basis or the modified accrual basis of accounting is required, except for the revenue recognition standards. Therefore, expenditures and liabilities for government-mandated and voluntary nonexchange transactions should be recognized in governmental funds when all applicable eligibility requirements are met. Numerous examples of the recognition of expenses from intergovernmental grants, entitlements, and shared revenues are provided in nonauthoritative appendixes of GASB Statements No. 33 and No. 36.

8.33 Paragraph 26 of GASB Statement No. 33 provides guidance on the contravention of provider stipulations. After a nonexchange transaction has been recognized in the financial statements, it may become apparent that (a) the eligibility requirements are no longer met or (b) the recipient will not comply with the purpose restrictions within the specified time limit. In those circumstances, if it is probable that the provider will not provide the resources or will require the recipient to return all or part of the resources already received, the provider should recognize a decrease in liabilities (or an increase in assets) and a revenue for the amount that it is expected to cancel or reclaim.

8.34 Governments often receive grants and other financial assistance to transfer to or spend on behalf of secondary recipients. Those amounts are referred to as *pass-through grants*. For example, state governments often pass through federal awards for community development, education, and social services programs to other governments, not-for-profit organizations, and individuals. Recipient governments may receive fees for administering pass-through grants, which they should report as revenues. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, requires that all cash pass-through grants received by a recipient government be reported in its financial statements. As a general rule, recipient governments should recognize cash pass-through grants as revenue and expenses/expenditures in a governmental, proprietary, or trust fund, and as revenue and expenses in the government-wide financial statements (unless reported in a trust fund). In those infrequent cases in which a recipient government serves only as a cash conduit (as defined in GASB Statement No. 24), the grant should be reported in an agency fund, in which case it would not be reported in the government-wide financial statements. A grantor may disallow costs for pass-through grants that do not comply with its requirements. As applicable, the provisions of GASB Statement No. 33 or FASB Statement No. 5, *Accounting for Contingencies*, apply in determining whether to accrue refund liabilities, accrue receivables from subrecipients, or disclose contingent liabilities for disallowed costs. (See paragraphs 8.47 and 8.49.)

8.35 On-behalf payments for fringe benefits and salaries are direct payments made by one entity (the paying entity or paying government) to a third-party recipient for the employees of another, legally separate entity (the employer entity or employer government). Such payments may be for pension plan contributions, employee health and life insurance premiums, and salary supplements or stipends. For example, a state government may make contributions directly to a pension plan for elementary and secondary schoolteachers employed in public school districts within the state. GASB Statement No. 24, paragraph 13, states that a paying government should classify the expenses/expenditures for the on-behalf payments that it makes in the same manner that it classifies similar cash grants to other entities. For example, if a state government classifies state aid payments to school districts as education expenditures, on-behalf payments of pension contributions for the school districts also should be classified as education expenditures, rather than as pension expenditures. (Chapter 6 discusses the revenue accounting and financial reporting for such on-behalf payments by the employer government.)

Unrelated Business Income Taxes

8.36 Certain governmental entities are subject to federal unrelated business income taxes (UBIT), which is a tax on income derived from any trade or business that is regularly carried on and not substantially related to the organization's tax-exempt purpose or function. The governmental entities subject to UBIT are those that have received federal income tax exemptions from the IRS, such as Section 501(c)(3) corporations, and governmental colleges and universities and their wholly owned subsidiary corporations. As with most federal tax provisions, the provisions for UBIT can be complex. Affected governments should report expenses/expenditures and liabilities for UBIT when the liability is incurred.

Fund-Raising Costs

8.37 Some governmental entities, such as colleges and universities and health care providers, solicit support through a variety of fund-raising activities. Sometimes fund-raising activities are conducted with activities related to other functions, such as program activities or supporting services. Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising. AICPA Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*,¹² included as appendix C of this Guide, establishes accounting and financial reporting standards for the costs of joint activities. It also requires disclosures about the nature the activities for which joint costs have been allocated and the amounts of joint costs. Although the SOP applies to all governments, its provisions are only meaningful for those entities that report using functional classifications.

Landfill Closure and Postclosure Care Costs

8.38 GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, as interpreted by GASB Interpretation No. 6, establishes standards of accounting and financial reporting for

¹² SOP 98-2 was cleared by the GASB before it was issued and includes governmental entities in its scope, and thus is category (b) guidance for governmental entities. See the discussion of the hierarchy of governmental generally accepted accounting principles (GAAP) in Chapter 1, "Overview and Introduction."

municipal solid waste landfill closure and postclosure care costs that are required to be incurred by federal, state, or local laws or regulations. GASB Statement No. 18, as interpreted, requires certain capital and operating costs that result in disbursements near or after the date that the landfill stops accepting solid waste and during the postclosure period to be included in the estimated total current cost of landfill closure and postclosure care.

8.39 In the proprietary fund and government-wide financial statements, a portion of the estimated total current cost of landfill closure and postclosure care should be recognized as an expense and liability in each period that the landfill accepts solid waste. Recognition should begin on the date the landfill begins accepting solid waste, continue in each period that it accepts waste, and be completed by the time it stops accepting waste. Estimated total current cost should be assigned to periods based on landfill use. Equipment, facilities, services, and final cover included in the estimated total current cost should reduce the accrued landfill closure and postclosure care liability when they are acquired. Using the measurement criteria discussed above, governmental funds should recognize expenditures and related fund liabilities for landfill closure and postclosure care costs as discussed in paragraphs 8.12 and 8.13.

8.40 Landfill owners or operators may be required to provide financial assurances for closure, postclosure care, and remediation of each landfill by placing assets with a third-party trustee or in a surety standby trust. GASB Statement No. 18, paragraph 15, states that those amounts should be reported in the fund used to report landfill operations and be identified by a description such as “amounts held by trustee.” Investment earnings on amounts set aside to finance closure and postclosure care should be reported as revenue, not as reductions of the estimated total current cost of landfill closure and postclosure care and related accrued liability.

8.41 GASB Statement No. 18, paragraph 17, requires certain disclosures in the notes to the financial statements concerning the nature and amount of landfill closure and postclosure care costs and liabilities.

Claims and Judgments: Risk Financing and Loss Contingencies

8.42 Claims and judgments include risk financing and insurance related activities, which are addressed in GASB Statements No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, and No. 30, *Risk Financing Omnibus*; and GASB Interpretation No. 4. The GASB staff document *Guide to Implementation of GASB Statement 10 on Accounting and Financial Reporting for Risk Financing and Related Insurance Issues: Questions and Answers* provides additional guidance.

8.43 GASB Statement No. 10, as amended and interpreted, establishes accounting and financial reporting standards for risk financing and insurance-related activities relating to risks of loss from torts; theft of, damage to, or destruction of assets; business interruption; errors or omissions; job-related illnesses or injuries to employees; and acts of God as well as losses from providing accident and health, dental, and other medical benefits to employees and retirees, and their dependents and beneficiaries, based on covered events that have already occurred. Governments may manage and finance those risks by, for example, purchasing commercial insurance, participating in public entity risk pools, or retaining the risk.

8.44 GASB Statement No. 10 provides that, except as discussed in paragraph 8.45 when an internal service fund is used, if part or all of a risk of loss

has not been transferred to an unrelated third party, the government should report an estimated loss as an expense and liability in the government-wide, proprietary fund, and trust fund financial statements if two conditions are met. Those conditions are that (a) information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements and (b) the amount of loss can be reasonably estimated. The estimated loss should include incurred but not reported (IBNR) amounts—(a) known loss events that are expected to later be presented as claims, (b) unknown loss events that are expected to become claims, and (c) expected future development on claims already reported—if those losses can be reasonably estimated and it is probable that a claim will be asserted. Additional guidance on measuring the liability is provided in GASB Statement No. 10, as amended and interpreted. Using the measurement criteria discussed above, governmental funds should recognize expenditures and related fund liabilities for those claims and judgments as discussed in paragraphs 8.12 and 8.13.

8.45 If a single fund is used to account for an entity's risk financing activities, that fund should be either the general fund or an internal service fund. (Stand-alone entities that engage only in business-type or fiduciary activities and that are not considered to be a part of another financial reporting entity should not use an internal service fund to report their own risk financing activities.)

- If a government uses the general fund, that fund should recognize claims expenditures and liabilities as discussed for governmental funds in paragraph 8.44 (including that paragraph's reference to paragraphs 8.12 and 8.13). The government may use any method to allocate claims expenditures to other funds, and generally should account for amounts charged to other funds from the general fund as interfund reimbursements. (Interfund reimbursements are discussed in Chapter 9.) However, if the total amount charged to the other funds (including the general fund itself) exceeds the total claims expenditures and liabilities recognized, the excess amounts should be reported as interfund transfers.
- If a government uses an internal service fund, that fund should recognize claims expenses and liabilities as discussed in paragraph 8.44. The total charge by the internal service fund to the other funds for the period should (a) equal the expense and liability recognized or (b) be based on an actuarial method or historical cost information and adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal (plus, if the government chooses to, a reasonable provision for expected future catastrophe losses). Those interfund charges should be recognized as revenue by the internal service fund and as expenses/expenditures by the other funds. Deficits, if any, in the internal service fund resulting from using method *b* do not need to be charged back to the other funds in any one year, as long as adjustments are made over a reasonable period of time. If the charge by the internal service fund to the other funds fails to recover the full cost of claims over a reasonable period of time, any deficit fund balance in the internal service fund should be charged back to the other funds and reported as expenses/expenditures of those funds. If the charge by the internal service fund to the other funds is greater than that permitted by methods *a* or *b*, the excess should be reported in both the internal service fund and the other funds as an interfund transfer.

8.46 GASB Statement No. 10, as amended and interpreted, also provides guidance on how governments should account for and report on their participation in public entity risk pools. The accounting and financial reporting requirements for public entity risk pools are discussed in Chapter 12.

8.47 Claims and judgments also involve loss contingencies—existing conditions that may create a legal obligation in the future but that arise from past transactions or events—resulting from all claims from actions not included in the scope of GASB Statement No. 10, as amended and interpreted (see paragraph 8.43). Those other claims include contractual actions, such as claims for delays or inadequate specifications on contracts, or for guarantees of the debt of others (see paragraph 8.78), unemployment compensation claims, and, subject to the guidance in GASB Statement No. 33, property tax appeals, tax refund claims, and refunds of nonexchange revenues when the government does not meet a provider's requirements. NCGA Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, as amended by GASB Statement No. 10, establishes the requirements of FASB Statement No. 5 as the guidelines for recognizing a loss liability in these situations. Under FASB Statement No. 5, a liability should be recognized when (a) information available prior to issuance of the financial statements indicates it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and (b) the amount of the loss can be reasonably estimated. Consequently, loss contingencies involve pending, threatened, or unasserted litigation, claims, or assessments as of the financial statement date. Using the measurement criteria discussed above, governmental funds should recognize expenditures and related fund liabilities for claims and judgments arising from loss contingencies as discussed in paragraphs 8.12 and 8.13.

8.48 Governments also may need to recognize loss contingencies and make note disclosures (including disclosure of material violations of finance-related legal provisions and actions taken to address such violations) relating to noncompliance with federal tax requirements, such as those relating to employment taxes and employee benefits. Those requirements may involve, for example, Federal Insurance Contributions Act (FICA) reporting and social security and Medicare coverage. The AICPA's annual Audit Risk Alert *State and Local Governmental Developments* often discusses common areas of non-compliance with federal tax requirements that affect governments.

8.49 GASB Statement No. 10, as amended and interpreted, and FASB Statement No. 5 require various disclosures relating to claims and judgments. For example:

- If no accrual is made for a loss contingency because one or both of the required conditions are not met, or if an exposure to loss exists in excess of the amount accrued, but there is a reasonable possibility that a loss or an additional loss may have been incurred, the financial statements should disclose the nature of the contingency and an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.
- The entity should describe the risks of loss to which it is exposed and the way(s) in which those risks of loss are handled; significant reductions in insurance coverage from coverage in the prior year by major categories of risk; whether the amount of settlements exceeded insurance coverage for each of the past three fiscal years; and the nature of participation in risk pools, including the rights and the responsibilities of both the entity and the pool.

- If an entity retains the risk of loss, it should disclose various data about recorded and unrecorded liabilities. (See GASB Statement No. 10, paragraph 77, as amended.)
- For risk financing internal service funds, deficit net assets should be disclosed and net assets that result from charging a reasonable provision for expected future catastrophe losses should be disclosed as designated net assets.

Operating Leases

8.50 Many governments enter into lease purchase agreements, installment purchase contracts, or other forms of capital asset financing agreements (collectively termed *lease agreements*). The accounting and financial reporting for lease agreements is described in NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, as amended by GASB Statements No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, and No. 14, *The Financial Reporting Entity*. This chapter discusses lessee accounting and financial reporting for operating leases; Chapter 7 discusses lessee accounting and financial reporting for capital leases. Chapter 6 discusses lessor accounting. Chapter 12 (in the section on financing authorities) discusses specialized standards for leases between a primary government and a component unit.

8.51 NCGA Statement 5, as amended, provides that the requirements of FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, are the guidelines for accounting and financial reporting for operating leases, except for operating leases with scheduled rent increases. GASB Statement No. 13, requires that transactions arising from operating leases with scheduled rent increases be measured based on the terms of the lease contract when the pattern of the payment requirements, including the increases, is systematic and rational. However, if the pattern of the payment requirements is not systematic and rational—for example, if there is a rent reduction or “rent holiday” that constitutes a financing arrangement between the lessor and the lessee, or if there are reduced rents to induce the lessee to enter into the lease—the operating lease transactions should be measured either (a) on a straight-line basis over the lease term or (b) based on the estimated fair value of the rental. GASB Statement No. 13 contains guidance on measuring the fair value of the rental.

8.52 The government-wide and proprietary and trust fund financial statements should recognize operating lease expenses using the measurement criteria discussed in paragraph 8.51.¹³ Governmental funds should recognize operating lease expenditures and report the related fund liabilities using the measurement criteria discussed in that same paragraph to the extent that the amounts are payable with expendable, available financial resources. (Note that the scope of GASB Interpretation No. 6 does not include operating leases with scheduled rent increases.)

8.53 NCGA Statement 5, as amended, requires governments to apply the disclosure requirements of FASB Statement No. 13, as amended and interpreted, including for operating leases with scheduled rent increases. NCGA Statement 1, paragraph 40, also requires disclosure of significant noncapitalized (operating) lease commitments. GASB Statement No. 38, *Certain Financial*

¹³ If the fair-value measurement is used for operating leases with scheduled rent increases, the interest portion of the expense should be recognized each period using the interest method.

Statement Note Disclosures, paragraph 11, requires governments to disclose the future minimum principal and interest payments for each of the five subsequent fiscal years and in five-year increments after that for both capital and operating leases.

Customer and Developer Deposits

8.54 Many electric, water, gas, sewer, and other utility operations require customer deposits to assure timely payment for services. Customer deposits to secure service payments normally are required before service starts and are refunded when service is terminated. Utility operations also may require land developers or individual property owners to make deposits as advance payments of system development fees to extend utility service lines to their properties. Utility operations generally are reported in enterprise funds, and unearned customer and developer deposits initially are recorded as liabilities in those funds and in the government-wide financial statements. Customer deposits remain as liabilities until they are applied against unpaid billings or refunded to customers. Developer deposits remain as liabilities until they are recognized as revenue from system development fees. (See Chapter 6.)

Deferred Charges

Prepaid Items

8.55 Prepaid items are payments for services, such as insurance or rent, before they are received. The government-wide, proprietary fund, and fiduciary fund financial statements should report prepaid items as assets until the services are received. GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*, has specific provisions for reporting prepaid insurance for capitalization contributions made to form or join a public entity risk pool. Governmental fund expenditures for services extending over more than one accounting period need not be allocated between or among accounting periods, but may be accounted for as expenditures of the period of acquisition. See Chapter 10, "Equity and Financial Statement Reconciliations," for a discussion of governmental fund balance reserves for prepaid items.

Inventory

8.56 Inventory is stocks of materials held for sale or use. The government-wide, proprietary fund, and fiduciary fund financial statements should report inventory items as assets until the materials are sold or used. In the governmental funds, inventory items may be considered expenditures either when purchased (purchases method) or when sold or used (consumption method). Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 4, "Inventory Pricing," which applies to the government-wide and proprietary fund financial statements (and which may be applied in the governmental and fiduciary funds),¹⁴ provides guidance for when supplies that are held for sale or to be used directly or indirectly in the production of goods or services to be available for sale should be written down to the lower of cost or market. Unless ARB No. 43 is applied, governmental fund inventories generally are not written down from cost to lower market values unless the usability of the inventory is affected by physical deterioration or obsolescence. NCGA Statement 1, paragraph 73, requires significant amounts of governmental fund inventories to be reported in the fund balance

¹⁴ See the discussion of the governmental GAAP hierarchy in Chapter 1 and the discussion of the applicability of certain private-sector accounting and financial reporting standards in Chapter 2.

sheet, even though they may be recognized as expenditures using the purchases method. If using the purchases method, that reporting is accomplished by recording a corresponding credit as a fund balance reserve for inventory. (See the further discussion in Chapter 10.)

8.57 ARB No. 43, Chapter 3A, “Working Capital—Current Assets and Current Liabilities,” paragraph 9, which applies to the government-wide and proprietary fund financial statements (and which may be applied in the governmental and fiduciary funds), requires disclosure of the basis for stating the various classifications of inventory items and, where practicable, the method used to determine their cost (such as average cost, first-in first-out, last-in first-out, and so forth). In addition, Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*, which applies to the government-wide and all fund financial statements because of the provisions of GASB Statement No. 34 and NCGA Statement 1, includes inventory pricing policies as a commonly required disclosure.

Escheat Property

8.58 Local governments often hold abandoned or unclaimed property for some period of time (often several years) before transmitting it to the state in accordance with escheat laws. GASB Statement No. 21, *Accounting for Escheat Property*, as amended by GASB Statements No. 34 and No. 37, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Omnibus*, indicates that escheat property held for individuals, private organizations, or another government should be reported in a private-purpose trust fund or in agency fund, as appropriate, or in the governmental or proprietary fund in which escheat property is otherwise reported, with a corresponding liability. As discussed in Chapter 2, “Financial Reporting,” private-purpose trust and agency funds (like all fiduciary funds) should not be reported in the government-wide financial statements. Chapter 12 discusses state government reporting of escheat property.

Agency Funds

8.59 Agency funds do not report liabilities for amounts owing to other funds of the government. If an agency fund is used as a clearing account to distribute financial resources to other funds, those resources should be reported as assets in the appropriate funds, not as interfund balances. (See also the discussion of amounts collected for individuals, other entities, and other fund in Chapter 6.)

Debt

8.60 The accounting for debt generally is based on whether the debt is short-term or long-term debt, not on whether the debt is current (that is, due to be paid within one year of the financial statement date) or noncurrent. Short-term debt instruments are those with original maturities of less than one year. Long-term debt instruments are those with original maturities of more than one year.

Short-term Debt Instruments

8.61 A government’s short-term debt instruments may take one of several forms:¹⁵

¹⁵ Some governments may issue revenue and bond anticipation notes with original maturities of more than one year. Such long-term anticipation notes are accounted for in accordance with the provisions of the GASB standards discussed in paragraphs 8.63 and 8.64.

- Revenue anticipation notes usually are secured by future revenues from one or more specific sources as well as by the government's unpledged assets. For example, tax and grant anticipation notes are secured by pledges of specific future tax and grant collections, respectively.
- Bond anticipation notes (BANs) are used primarily to provide interim construction financing and usually are retired with the proceeds of long-term debt. BANs are frequently refinanced by replacement notes if the original notes mature before the long-term debt is issued. Although the issuance of the long-term debt may be delayed pending improvement in market conditions, governments usually issue long-term debt before starting construction.
- Other short-term debt instruments (such as commercial paper) usually are secured only by the pledge of the full faith and credit of the government (principally its taxing power).

8.62 Short-term debt generally is reported as a liability in the government-wide financial statements and in the financial statements of the fund receiving the proceeds. (See the exception for governmental fund BANs in certain situations in paragraph 8.63.) The issuance of the debt and the repayment of debt principal affect only the financial position statements; only the interest on the debt is reported in the activity statements. APB Opinions No. 12, *Omnibus Opinion—1967*, and No. 21, *Interest on Receivables and Payables*, which are required for the government-wide and proprietary fund financial statements (and which may be applied in the governmental and fiduciary funds)¹⁶ provide certain guidance on the accounting and financial reporting for debt transactions. In particular, APB Opinion No. 21 requires a debt issuance discount or premium to be amortized as interest expense or income over the life of the debt using the “interest” method, which is described in APB Opinion No. 12. APB Opinion No. 21 also requires a discount or premium to be reported in the financial position statements as a direct deduction from or addition to the face amount of the debt and issue costs to be reported as deferred charges. APB Opinion No. 21 does not specify an amortization method for issue costs.

Bond and Other Anticipation Notes

8.63 NCGA Interpretation 9, *Certain Fund Classifications and Balance Sheet Accounts*, as amended by GASB Statement No. 34, provides that in certain situations, BANs are not reported in governmental funds. If all legal steps have been taken to refinance governmental fund BANs and the intent is supported by an ability to consummate refinancing the short-term notes on a long-term basis in accordance with the criteria in FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced*, the BANs should not be reported in the governmental funds but only as general long-term liabilities in the governmental activities column of the government-wide statement of net assets. NCGA Interpretation 9, as amended, also requires that proprietary fund bond, tax, and revenue anticipation notes be reported as current or long-term liabilities depending on the refinancing status in accordance with the criteria in FASB Statement No. 6. If a short-term obligation is excluded from fund or current liabilities, the notes to the financial statements should describe the financing agreement and the terms of any new obligation incurred or expected to be incurred as a result of a refinancing.

¹⁶ See footnote 14.

8.64 NCGA Interpretation 9 also requires that tax and revenue anticipation notes be reported as a liability in the governmental fund receiving the proceeds. This requirement is without regard to whether the tax and revenue anticipation notes are short- or long-term instruments.

Long-Term Debt Instruments

8.65 A government's long-term debt instruments generally take one of two forms:^{17, 18}

- General obligation bonds pledge the full faith and credit of the government to pay debt principal and interest.
- Revenue (or limited-liability) bonds pledge specific receipts (such as gasoline taxes, special assessments, utility revenues, and highway or bridge tolls) to pay debt principal and interest. Revenue bonds include tax-increment bonds, which sometimes are issued in connection with economic development projects where future property tax revenues to be generated by new development are pledged to pay for the obligations issued. Revenue bonds also include bonds that are issued by governments, often financing authorities, to finance equipment or facilities that are leased to another entity. The lease payments are pledged to pay the debt principal and interest. Sometimes, lease-backed revenue bonds are issued in a form known as certificates of participation (COPs). (See the discussion of the accounting for lease-backed bonds in the section on financing authorities in Chapter 12.) Depending on the expectations for future revenues, or to improve the market for or lower the interest rate on the debt, governments also may pledge their full faith and credit on revenue bonds.

8.66 NCGA Statement 1 provides that liabilities arising from long-term debt that is directly related to and expected to be paid from proprietary funds should be reported in the proprietary fund and government-wide financial position statements. (This includes general obligation bonds that are expected to be retired from proprietary fund revenues.) Liabilities arising from long-term debt that is directly related to and expected to be paid from fiduciary funds should be reported only in the statement of fiduciary net assets. The accounting for long-term proprietary and fiduciary fund debt is the same as for short-term debt; see paragraph 8.62.

8.67 All other unmatured liabilities arising from long-term debt are general long-term liabilities. Those liabilities should not be reported as liabilities in governmental funds but should be reported in the government-wide statement of net assets, typically in the governmental activities column. Matured but unpaid portions of general long-term debt should be reported as liabilities in both the governmental fund and government-wide financial statements. The accounting for general long-term debt that is reported in the government-wide financial statements is the same as for short-term debt; see paragraph 8.62.

8.68 In the governmental funds, except for certain demand bonds as discussed in paragraph 8.70, the face amount of long-term debt issuances is reported as an other financing source in the fund that receives the debt proceeds.

¹⁷ Some state and local laws also may define capital leases as long-term debt instruments for purposes such as debt limitations. Chapter 7 discusses lessee accounting and financial reporting for capital leases.

¹⁸ See footnote 15.

Debt issuance premiums and discounts should be reported as other financing sources and uses, respectively, and debt issue costs paid out of debt proceeds, such as underwriter fees, should be reported as expenditures.

8.69 Expenditures for the payment of principal and interest on general long-term debt are reported when the payments are due (matured). In addition, debt service expenditures may be reported if a government has provided financial resources to a debt service fund for payment of debt that will mature early in the following year. A government has “provided” financial resources to a debt service fund if it has deposited in or transferred to that fund financial resources that are dedicated for payment of debt service. “Early in the following year” refers to a short time period—usually one to several days and not more than one month. Debt service activities should be reported in debt service funds if those funds are legally mandated or if financial resources are being accumulated for principal and interest payments maturing in future years. Legal mandates may arise from bond agreements requiring a *reserve fund* to accumulate debt service resources or from voter approvals to issue the debt and to pay the debt through a separate tax levy. (Such reserve funds are more appropriately described as *accounts* rather than as *funds*.¹⁹) Many governments establish individual debt service funds for each debt issue, even though not required by legal or contractual provisions or generally accepted accounting principles (GAAP). However, some governments combine individual debt service funds into a single debt service fund for financial reporting purposes.

Demand Bonds

8.70 Demand bonds are debt issuances that give the bondholder the right to require the issuer or its agent to redeem the bonds within a certain period after giving notice, creating a potential call on current resources. GASB Interpretation No. 1, *Demand Bonds Issued by State and Local Governmental Entities*, as amended by GASB Statement No. 34, provides guidance for bonds that have demand provisions that can be exercised at the date of the financial statements or within one year thereafter. Those bonds should be reported as general long-term liabilities (and reported only in the government-wide statement of net assets, but not in the governmental funds balance sheet) or excluded from current liabilities of proprietary funds if all of four conditions specified in GASB Interpretation No. 1, as amended, are met. Those conditions ensure that any bonds for which demand provisions are exercised will not require the current use of the government’s resources. Unless those conditions are met, demand bonds should be reported as liabilities in governmental funds or, in the case of proprietary funds, as current liabilities. GASB Interpretation No. 1, paragraph 11, requires certain note disclosures about demand bond programs, liquidity agreements, take out agreements, and the debt service requirements that would result if the take out agreement were to be exercised.

Special Assessment Debt

8.71 Special assessment debt is a long-term obligation for which assessments levied against the benefiting properties are the primary source of repayment. Sometimes a government pays a portion of the cost of an improvement, in recognition of a “public benefit” that results from the project. Frequently, a government will be obligated in some manner to provide resources for repayment of special assessment debt in the event of default by the assessed property owners.

¹⁹ Chapter 2 discusses the auditor’s consideration of whether legal or contractual provisions require the use of separate funds for financial reporting purposes.

8.72 GASB Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, as amended by GASB Statements No. 33 and No. 34, provides the accounting and financial reporting standards for special assessment projects, which differ depending on whether the government is obligated in some manner to assume the payment of related debt service in the event of default by the property owners. A government is obligated in some manner for special assessment debt if (a) it is legally obligated to assume all or part of the debt in the event of default or (b) the government may take certain actions to assume secondary liability for all or part of the debt—and the government takes, or has given indications that it will take, those actions. GASB Statement No. 6 provides additional guidance on the “obligated in some manner” criterion.

8.73 If a government is obligated in some manner for special assessment debt, all transactions related to capital improvements financed by special assessments should be reported in the same manner, and on the same basis of accounting, as any other capital improvement and financing transaction. Depending on the administration of a special assessment project and the fund that is expected to pay the government’s share of the project debt, if any, the transactions may be reported using proprietary or governmental funds and accounted for as discussed in paragraphs 8.66, and 8.67 through 8.69, respectively.

8.74 GASB Statement No. 6 provides that if the government is not obligated in any manner for special assessment debt, the debt is not reported in the government’s financial statements, and transactions of the debt service phase are reported in an agency fund. If the construction phase of the project is reported in a capital projects or other governmental fund, the source of funds is identified by a description other than “bond proceeds,” such as “contribution from property owners.” If the project is reported in a proprietary fund, an amount equal to the amount capitalized in the fund (for the capital asset) should be reported on the accrual basis after nonoperating revenue and identified by a description such as “contribution from property owners.” In the government-wide financial statements, program revenue (capital grants and contributions) equal to the amount capitalized (for the capital asset) should be reported.

8.75 GASB Statement No. 6, paragraphs 20 and 21, provides disclosure requirements for special assessment debt. If the government is obligated in some manner for special assessment debt, it should disclose the information required for long-term debt (see the later section in this chapter entitled “Other Disclosures in the Notes to the Financial Statements”). The government also should describe the nature of its obligation, including identifying any guarantee, reserve, or sinking fund established to cover defaults by property owners. If the government is not obligated in any manner for special assessment debt, the notes should disclose the amount of the debt and the fact that the government is in no way liable for repayment.

Conduit Debt

8.76 Governments sometimes issue conduit debt, which is certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments to provide capital financing for a specific third party that is not a part of the issuer’s financial reporting entity. Although conduit debt instruments bear the name of the governmental issuer, the issuer has no obligation for the debt beyond the resources provided by a lease or loan with the benefiting third party. The proceeds from the sale of such debt usually advance or achieve some public purpose, such as hospital construction or the expansion of a private business to increase employment or the government’s tax base. Normally, such

debt is repayable only by the benefiting third party. Conduit debt explicitly states that the government has no obligation other than possibly to help creditors exercise their rights in the event of default.

8.77 Some governments report conduit debt as liabilities in their financial statements whereas other governments do not. GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*, does not establish accounting standards for conduit debt. However, it does state that some conduit debt issuers report the obligations as liabilities and that the interpretation does not alter that reporting or the reporting of future, substantially similar conduit debt obligations. GASB Interpretation No. 2 requires governments with conduit debt obligations to disclose a general description of the conduit debt transactions, the aggregate amount of all conduit debt obligations outstanding at the financial statement date, and a clear indication that it has no obligation for the debt beyond the resources provided by related leases or loans. See the further discussion of conduit debt obligations in the section on financing authorities in Chapter 12.

Debt Guarantees

8.78 Some governments may be legally or morally obligated for the debt of other entities. A legal obligation would be one in which one government has—through law or contract—agreed to pay the debt of another entity should the other entity be unable to do so. On the other hand, a moral obligation is usually unenforceable unless authorization to pay is adopted by the entity's governing body. An example is debt issued by a local government for which the state government is obligated, in the event of default, to consider assuming responsibility for total repayment or to consider annually the need to provide the required debt service payments. For guarantees arising from legal and moral obligations to pay the debt of other entities (except for special assessment debt as discussed in paragraphs 8.71 through 8.75), governments should apply the requirements of NCGA Statement 4, as amended and interpreted, which requires liabilities for contingencies arising from such guarantees to be recognized and reported using the criteria of FASB Statement No. 5. (See paragraph 8.47.) In addition, GAAP requires the disclosure of significant commitments. (See paragraph 8.82.)

Advance Refundings and In-Substance Defeasances

8.79 GASB Statements No. 7, *Advance Refundings Resulting in Defeasance of Debt*, and No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, as amended by GASB Statement No. 34, provide guidance on the accounting and financial reporting for advance and current refundings that result in the defeasance of debt. In a refunding, a government issues new debt to finance the repayment of previously issued (old) debt. The repayment of the old debt may either be immediate (a current refunding) or at some future time (an advance refunding).

8.80 An advance refunding may defease the old debt, either legally or in-substance. A legal defeasance occurs when debt is legally satisfied based on certain provisions in the debt instrument even though the debt is not actually paid. Debt is defeased in substance if the government irrevocably places cash or other assets with an escrow agent in a trust to be used solely to satisfy scheduled interest and principal payments of the debt, and the possibility that the government will be required to make future payments on that debt is remote. (See the criteria for an in-substance defeasance in GASB Statement No. 7, paragraph 4.) When debt is defeased, neither that liability nor the escrowed assets are reported in the financial statements. Only the new debt is reported.

- For current and advance refundings that defease general long-term debt, the face amount of the new debt should be reported as an “other financing source—proceeds of refunding bonds” in the governmental fund receiving the proceeds. Payments to the escrow agent from resources provided by new debt should be reported as an “other financing use—payment to refunded bond escrow agent.” Payments to the escrow agent from other resources should be reported as debt service expenditures.
- For current and advance refundings that defease proprietary fund debt, GASB Statement No. 23 requires that the difference between the reacquisition price and the net carrying amount of the old debt be deferred and amortized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. In the proprietary fund statement of fund net assets, this deferred amount should be reported as a deduction from or an addition to the new debt liability. The new debt may be reported “net,” with either parenthetical or note disclosure of the deferred amount on refunding; or it may be reported “gross,” with both the debt liability and related deferred amount presented in the statement of fund net assets. GASB Statement No. 23, as amended, provides additional standards for debt that refunds previous refunding debt.
- In the government-wide financial statements, current and advance refundings, including refundings of general long-term debt, should be reported in the same manner as in proprietary fund financial statements. (See the previous bulleted item.)

8.81 In all periods following an advance refunding for which debt that was defeased in substance remains outstanding, governments should disclose the outstanding amount of that debt, if any, at the financial statement date. In addition, GASB Statements No. 7 and No. 23, as amended, require the following disclosures in the year of the refunding: (a) a general description of the transaction, (b) the difference between the cash flows required to service the old debt and the cash flows required to service the new debt and complete the refunding, (c) the economic gain or loss resulting from the transaction. GASB Statement No. 7 provides guidance on the various measures needed for those disclosures.

Commitments

8.82 Governments are subject to various commitments, which are existing arrangements to enter into future transactions or events, such as long-term contractual obligations with suppliers for future purchases at specified prices and sometimes at specified quantities. NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4, requires note disclosure about construction and other significant commitments. (See also Chapters 10 and 11 concerning the reporting of encumbrances, which are commitments against the government’s appropriations for unperformed contracts for services and undelivered goods.)

Activity Statement Classifications

Government-Wide Statement of Activities

8.83 As discussed in Chapter 2, the government-wide statement of activities presents activities accounted for in governmental funds by function and

activities accounted for in enterprise fund by different identifiable activities. (GASB Statement No. 34 and this Guide use the term *function* to refer to the level of detail presented in the statement of activities for both governmental and business-type activities.) GASB Statement No. 34 requires resource outflows from other than transfers—expenses in this case—to be classified by function except those that meet the definition of special or extraordinary items (as discussed in paragraph 8.85). At a minimum, governments should report direct expenses for each function.²⁰ Direct expenses are those that are specifically associated with a service, program, or department and, thus, clearly identifiable to a particular function. Some functions (such as general government, support services, or administration) include expenses that are, in essence, indirect expenses of other functions. Although governments are not required to allocate those indirect expenses among other functions, they may allocate some or all of them. If indirect expenses are allocated, direct and indirect expenses should be presented in separate columns in the statement of activities. A column totaling direct and indirect expenses may be presented but is not required. (See the discussion in Chapter 9 about the requirement to eliminate allocations of overhead and similar expenses.)

8.84 GASB Statement No. 34 also provides classification standards for expenses for depreciation on general long-term assets and interest on general long-term liabilities. Chapter 7 discusses those classifications for depreciation expense. Interest on general long-term liabilities should be reported as an indirect expense except in those limited instances when borrowing is essential to the creation or continuing existence of a program and it would be misleading to exclude the interest from direct expenses of that program (for example, a new program that is highly leveraged in its early stages). Most interest on general long-term liabilities should be reported in the statement of activities as a separate line that clearly indicates that it excludes direct interest expenses, if any, reported in other functions. The amount excluded should be disclosed in the notes or presented on the face of the statement.

8.85 Special items are transactions or other events within the control of management that are either unusual in nature or infrequent in occurrence. (APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended and interpreted, defines the terms *unusual in nature* and *infrequency of occurrence*.) Extraordinary items are transactions or other events that are both unusual in nature and infrequent in occurrence. Special items should be reported before extraordinary items. The GASB 34 Q&A, item 141, provides the following examples of items that may be special items: special termination benefits resulting from workforce reductions due to sale of utility operations; early retirement program offered to all employees; and forgiveness of significant debt. It also provides the following examples of items that may be extraordinary items: costs related to an environmental disaster caused by a large chemical spill in a train derailment in a small city and significant damage to the community or destruction of government facilities by a natural disaster (tornado, hurricane, flood, earthquake, and so forth) or terrorist act. According to the provisions of FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, paragraph 8, as amended by FASB Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*, gains and losses from

²⁰ As discussed in Chapter 2, GASB Statement No. 34 encourages governments to provide data in the statement of activities at a more detailed level than by function if doing so provides more useful information without significantly reducing the statement's understandability.

extinguishments of debt usually should be aggregated and, if material, classified as an extraordinary item. Except as discussed in the rest of this paragraph, that standard applies to extinguishments of debt that are reported as gains and losses in proprietary funds and the government-wide financial statements. As discussed in Chapter 2, enterprise funds can elect to apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. In those enterprise funds that make that election (and in the related portions of the government-wide financial statements), the provisions of APB Opinion No. 30 apply, and the gains and losses from debt extinguishments are not classified as an extraordinary item because FASB Statements No. 4 and 64 were rescinded by FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, rescinded FASB Statements No. 4 and 64.

Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances

8.86 In the governmental funds, resource outflows from other than transfers should be reported as expenditures, classified at a minimum by function, unless they are required to be reported as other financing uses, special items, or extraordinary items. Expenditures also should be classified by character, that is, on the basis of the fiscal period they are presumed to benefit. The major character classifications of expenditures are *current*, which benefit the current fiscal period; *capital outlays*, which are presumed to benefit both the present and future fiscal periods; *debt service*, which presumably benefits prior fiscal periods as well as current and future periods, and *intergovernmental*, where one government transfers resources to another.

8.87 Other financing uses, which should be reported with other financing sources after the excess (deficiency) of revenues over expenditures, should include long-term debt issuance discounts (see paragraph 8.68) and payments to escrow agents for bond refundings paid from resources provided by the new debt (see paragraph 8.80). Special and extraordinary items (see paragraph 8.85) should be reported separately after other financing sources and uses. If both special and extraordinary items occur during the same period, they should be reported separately within a special and extraordinary items classification.

Proprietary Funds Statement of Revenues, Expenses, and Changes in Fund Net Assets (or Fund Equity)

8.88 In the proprietary funds, resource outflows from other than transfers are classified as operating expenses, nonoperating expenses, special items, or extraordinary items. Chapter 6 discusses the GASB Statement No. 34 requirements for defining operating revenues and expenses. Paragraph 8.85 discusses special and extraordinary items. Operating and nonoperating expenses should be detailed. The GASB 34 Q&A, item 211, indicates that the required detail may be provided by using natural classifications (for example, salaries and wages, employee benefits, supplies, utilities) or functions (a public university, for example, may use instruction, academic support, student services, and so forth).

Fiduciary Funds Statement of Changes in Fiduciary Net Assets

8.89 This statement reports only trust funds; agency funds should not be reported in this statement. Resource outflows are classified as deductions. The

detailed display requirements of GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*; and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*, apply to the statements of changes in plan net assets for pension and other employee benefit trust funds. (See Chapter 12.)

8.90 Agency fund activities are reported in a statement of changes in assets and liabilities that may be presented as supplementary information other than RSI, known as SI,²¹ for example, in the combining and individual fund financial statements in a comprehensive annual financial report. That statement presents changes in all assets and liabilities, not only cash transactions.

Financial Position Statement Classifications

8.91 GASB Statement No. 34 requires the government-wide statement of net assets to present assets and liabilities in order of liquidity (which is encouraged) or classified between current and long-term. It also requires assets and liabilities of proprietary funds to be classified between current and long-term assets and liabilities. Chapter 2 discusses the requirements for those presentations. The detailed display requirements of GASB Statements No. 25 and No. 26 apply to the statements of plan net assets of pension and other employee benefit trust funds.

8.92 If proprietary or trust fund liabilities for which the government is contingently liable are in default—or if it is probable that those liabilities will not be paid on a timely basis from the resources of those funds and default is imminent—NCGA Statement 1, paragraph 46, as amended, requires the liabilities to be reported separately from other liabilities in the fund balance sheet and in the government-wide statement of net assets. The notes to the financial statements should disclose all significant facts with respect to the situation.

Other Disclosures in the Notes to the Financial Statements

8.93 Earlier portions of this chapter discuss many of the disclosures required for transactions and balances discussed in this chapter. Other required disclosures include:

- The accounting principles used for recognizing expenses/expenditures (NCGA Statement 1, paragraph 69, and APB Opinion No. 22)
- Material violations of finance-related legal and contractual provisions and actions taken to address such violations (NCGA Statement 1, paragraph 158, and GASB Statement No. 38, paragraph 9)
- The government's policy for allocating indirect expenses to functions in the government-wide statement of activities (GASB Statement No. 34, paragraph 115)
- The government's policy for whether it first applies restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available (GASB Statement No. 34, paragraph 115)

²¹ The auditor's responsibility for and reporting on supplementary information other than RSI, known as SI, are discussed in Chapters 4, "Planning the Audit," and 14, "Audit Reporting," respectively.

- Short-term debt activity during the year, including a schedule of changes in that debt and the purpose for which the debt was issued (GASB Statement No. 38, paragraph 12)²²
- Certain disclosures about debt that has derivative or similar features (See GASB Technical Bulletin (TB) No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*.)
- Significant effects of subsequent events (NCGA Statement 1, paragraph 158)
- Debt service requirements to maturity, presenting principal and interest requirements separately for each of the five subsequent fiscal years and in five-year increments after that (NCGA Statement 1, paragraph 158, and GASB Statement No. 38, paragraph 10) (Note that interest requirements for variable-rate debt should be calculated using the rate in effect at the financial statement date.)
- The terms by which interest rates change for variable-rate debt (GASB Statement No. 38, paragraph 10)
- Details about payables aggregated in the financial statements when those aggregations obscure significant components of the payables (GASB Statement No. 38, paragraph 13)²³

8.94 Paragraphs 116 and 119 of GASB Statement No. 34 require governments to provide the following details in the notes to the financial statements about the primary government's long-term liabilities (both long-term debt and other long-term liabilities) except net pension obligations.²⁴ The information in the disclosure should be divided into major classes of long-term liabilities as well as between type of activity (governmental versus business-type):

- Beginning- and end-of-year balances
- Increases and decreases (separately)
- The portions of each item that are due within one year of the financial statement date
- Which governmental funds typically have been used to liquidate other long-term liabilities (such as compensated absences and pension liabilities) in prior years

8.95 GASB Statement No. 34, as amended by GASB Statement No. 37, also requires the disclosure of certain segment information for governments that report enterprise funds or that use enterprise fund accounting and reporting standards to report their activities. For purposes of that disclosure, a segment is an identifiable activity (or grouping of activities) reported as or within an enterprise fund or an other stand-alone entity that has one or more bonds or other debt instruments outstanding, with a revenue stream pledged in support of that debt and an externally-imposed requirement for the activity's

²² Governments that are required to apply GASB Statement No. 34 for financial statements for periods beginning after June 15, 2001 (phase 1 governments) are not required to apply this provision of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, until financial statements for periods beginning after June 15, 2002, although earlier application is encouraged. However, they continue to be required by NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 5, to disclose information about short-term debt.

²³ Governments that are required to apply GASB Statement No. 34 for financial statements for periods beginning after June 15, 2001 (phase 1 governments) are not required to apply this provision of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, until financial statements for periods beginning after June 15, 2002, although earlier application is encouraged.

²⁴ Information about net pension obligations should be disclosed in a separate note as required by GASB Statement No. 27.

revenues, expenses, gains and losses, assets, and liabilities to be accounted for separately. However, segment disclosures are not required (a) for an activity whose only outstanding debt is conduit debt for which the government has no obligation beyond the resources provided by related leases or loans or (b) when an individual fund is both a segment and reported as a major fund.²⁵ GASB Statement No. 34, paragraph 122, contains the required segment disclosures, which should be met by providing condensed financial statements in the notes to the financial statements and describing the types of goods and services provided. GASB Statement No. 34, paragraph 123, encourages governments that want to present disaggregated data for their multiple-function enterprise funds beyond what is required for segment reporting (for example, net program cost information) to present a statement of activities as SI.

Management's Discussion and Analysis

8.96 As discussed in Chapter 2, GASB Statement No. 34 requires the presentation of a management's discussion and analysis (MD&A) as RSI.²⁶ One of the requirements for presentation in MD&A is long-term debt activity during the year, including a discussion of changes in credit ratings and debt limitations that may affect the financing of planned facilities or services. As an alternative, governments may summarize in the MD&A the information in the note disclosure discussed in paragraph 8.94 and refer to that disclosure for additional details.

8.97 MD&A also should include a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations. According to the GASB 34 Q&A, item 13, examples of currently known facts, decisions, or conditions related to expenses/expenditures and liabilities that might be expected to have a significant effect on financial position or results of operations are: the adjudication of a significant lawsuit, a flood that caused significant damage to a government's infrastructure, and a renegotiated labor contract with government employees.

Auditing Considerations

8.98 The audit objectives for expenses/expenditures and liabilities, categorized by financial statement assertion, are as follows:

- *Existence or Occurrence.* Recorded expenses/expenditures and liabilities represent valid transactions and, where applicable, are properly authorized.
- *Completeness.* All expenses/expenditures and liabilities are identified, recorded, and disclosed.
- *Rights and Obligations.* All expenses/expenditures and liabilities are accounted for in accordance with legal and contractual provisions that have a direct and material effect on the determination of financial statement amounts.
- *Valuation or Allocation.* All expenses/expenditures and liabilities are reported at appropriate amounts and in the appropriate funds.

²⁵ The GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers*, items 104 and 236, explains that common segments should not be grouped for purposes of the disclosure.

²⁶ See footnote 10.

- *Presentation and Disclosure.* All expenses/expenditures and liabilities are properly classified and adequately disclosed. Financial statement presentation and disclosure are in conformity with GAAP consistently applied.

8.99 The auditor might determine the various types of expenses/expenditures and liabilities that a government has by, for example, reading documents that contain legal and contractual provisions, such as budgets, enabling legislation, and grant agreements; asking appropriate officials about functions, programs, and resource use; and reviewing the financial statements of the prior period and the draft financial statements or other accounting information for the current period. After identifying the nature and amounts of expenses/expenditures and liabilities, the auditor should obtain an understanding of internal control over and assess control risk for relevant processes such as purchasing and payroll, accounting for expenses/expenditures and liabilities, and making cash disbursements.

8.100 The auditor should be aware of the possibility of the decentralization of the entity's purchasing and payroll, accounting, or disbursement activities, perform procedures to identify the various locations that conduct such activities, and assess control risk at each location that may materially affect the financial statement assertions. If a service organization is used (for example, in connection with the entity's purchasing and payroll, accounting, or disbursement activities), the auditor should consider the guidance of SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, AU sec. 324). Also see the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as amended* for clarification regarding the guidance in SAS No. 70, for clarification.

8.101 The extent of a government's internal control usually will not be the same for all types of transactions, and consequently neither is control risk. For example, a government may have more stringent controls over its payroll and payroll-related transactions (which usually is a significant cost for governments) than it does over its contracts for goods and services (which may not be as large a cost). Sometimes, increased controls are a result of the government's budgetary system. In designing an efficient and effective approach to the audit of expenses/expenditures and liabilities, the auditor should consider the differing levels of internal control and control risk for different types of costs.

8.102 As explained in Chapter 11, even though a government's budgetary comparison information may not be presented as a basic financial statement, an auditor may perform audit procedures relating to the budget to consider, for example, controls to ensure that expenses/expenditures have been properly approved, monitored and enforced, and classified within the accounts and thus assist in the audit of those items. If the auditor determines that those budgetary controls are in place and functioning properly, the auditor may be able to assess control risk for expenses/expenditures at less than the maximum and use those controls as a basis for reducing the nature, timing, and extent of substantive tests of expenses/expenditures that otherwise may be necessary.

8.103 A significant concern in auditing a government's financial statements is evaluating whether the entity has complied with the eligibility requirements, purpose restrictions, and other requirements in laws and contracts that could have a direct and material effect on the determination of financial statement amounts. Further, the auditor needs to determine that adequate procedures are performed related to the activity and balances of each of those opinion units with material expenses/expenditures and liabilities. (See the discussion of opinion units in Chapter 4.)

8.104 The auditor should obtain an understanding of the government's internal control over expenses/expenditures and liabilities. In addition to standard internal control features for those accounts, features that are unique or significant in government may include the following:

- Policies and procedures to ensure that the goods and services (including employee services) acquired and the related cash disbursements conform to legal and contractual provisions
- Processes to monitor that the government complies with the eligibility requirements, purpose restrictions, and other compliance requirements of intergovernmental grants and entitlements and private contributions
- Policies for first applying restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available, and procedures to ensure that policy is consistently applied
- Policies and procedures to appropriately allocate grant funds to recipients and subrecipients, to define compliance requirements and to communicate those requirements to recipients and subrecipients, and to monitor recipient and subrecipient activities on a timely basis
- Policies and procedures to ensure that debt issuances comply with legal and contractual provisions—such as debt limits, approvals by senior levels of government and voters, adherence to debt covenants, and the timely payment of debt principal and interest—and that taxes levied to service the debt are adequate (See also the discussions in Chapter 5 concerning federal arbitrage requirements.)
- Policies and procedures for recognizing expenses/expenditures and liabilities for UBIT
- Policies and procedures to record encumbrances for contracts and purchase orders
- Policies and procedures to ensure the proper use of petty cash and debit cards for small purchases
- The review of long-outstanding checks for propriety and the escheatment of abandoned and unclaimed funds that arise from long-outstanding checks
- Policies and procedures to ensure that expenses/expenditures, prepaid items and inventory, liabilities, debt issuances, and commitments are measured, presented, and disclosed in the financial statements in conformity with GAAP, including processes to ensure that expenses/expenditures are properly classified, as appropriate, by function, object, character, and operating/nonoperating designations; that special and extraordinary items are separately identified; and that liabilities, including debt, are reported in the proper fund and financial statements and properly classified as to liquidity or between current and long-term

8.105 In addition to standard audit procedures for expenses/expenditures and liabilities, procedures that are unique or significant in government may include the following:

- Examining a sample of expenses/expenditures to determine whether the goods and services acquired and the related cash disbursements conform to compliance requirements that could have a direct and material effect on the determination of financial statement amounts;

the entity adheres to its policy concerning first applying restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available; and expenses/expenditures, prepaid items and inventory, and liabilities are properly recorded and classified in the accounting records

- Examining a sample of intergovernmental grants and entitlements and private contributions to determine whether the entity complies with the awards' eligibility requirements, purpose restrictions, and other compliance requirements (such as those relating to subrecipients) that could have a direct and material effect on the determination of financial statement amounts
- Examining a sample of debt issuances to determine whether they comply with compliance requirements that could have a direct and material effect on the determination of financial statement amounts and that taxes levied to service the debt are adequate
- Making inquiries of responsible officials and reviewing correspondence from grantor agencies, other contributors, bond trustees, and so forth for noncompliance with legal and contractual provisions and for unrecorded and unreported contingencies
- Evaluating whether the entity has properly recorded expenses/expenditures and liabilities for UBIT
- Determining whether year-end encumbrances are appropriately recorded for outstanding contracts and purchase orders, and that recorded encumbrances are valid
- Examining a sample of petty cash and debit cards purchases for propriety and documentation
- Determining that the government has appropriately reversed long-outstanding checks and that such abandoned or unclaimed amounts have been handled properly in accordance with state escheat laws
- Determining whether the entity's expenses/expenditures, prepaid items and inventory, liabilities, debt issuances, and commitments are measured, presented, and disclosed in the financial statements in conformity with GAAP

8.106 Statement on Auditing Standards (SAS) No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, Professional Standards, vol. 1, AU sec. 332), provides guidance on planning and performing auditing procedures for financial statement assertions about derivative instruments, which include certain liabilities. Auditors should consider the guidance of SAS No. 92, which is summarized in Chapter 5, and the related AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* in their audits of governmental financial statements.

8.107 The auditor may use confirmations to verify certain information with other parties, such as IRC Section 457 plan balances, additions, and deductions with the plan administrator; grants, entitlements, and appropriations awarded and paid with recipients and subrecipients; deposits for systems development fees with land developers or individual property owners; landfill closure, postclosure care, and remediation assets with the trustee; legal compliance of debt sales with bond counsel or appropriate oversight government; the existence of debt restrictions, terms, and proceeds with debt lenders or underwriters; debt principal balances outstanding at the financial reporting

date and compliance with debt covenants with the trustee; and principal and interest payments during the year and cash held to pay matured or unmatured debt with the paying agent. See SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), for guidance about the confirmation process.

8.108 As discussed in paragraph 8.08, some grants, donations, and debt agreements impose finance-related requirements on the issuer. Although accounting and financial reporting standards and changes in those standards are not specifically designed to affect the evaluation of compliance with those requirements, some of those requirements may be written in such a manner that they could be affected. For example, a debt agreement may require a debt service reserve account that is based on a percentage of a particular revenue as reported in the government's GAAP financial statements. Because revenues may be measured differently in the government-wide and governmental fund financial statements, the government should determine the measure on which compliance should be evaluated. The government may need to consult the grantor, donor, or legal counsel in determining the effect of accounting and financial reporting standards on compliance requirements. The auditor should consider the need to evaluate the government's determination as part of the financial statement audit.

Transition to GASB Statement No. 34

8.109 GASB Statement No. 34 discontinues the reporting of general long-term liabilities in the fund-based financial statements. Accordingly, there is no longer a general long-term debt account group. General long-term liabilities are reported only in the government-wide financial statements, typically in the governmental activities column. However, financial resource inflows and outflows from issuing and repaying general long-term debt continue to be reported in the governmental funds.

8.110 GASB Statement No. 34 permits governments to apply certain private-sector standards and GASB proprietary activity standards that affect expenses and liabilities on a prospective basis only to governmental activities in the government-wide financial statements. See the discussion in the transition section of Chapter 2.

Chapter 9

Interfund, Internal, and Intra-Entity Activity and Balances

Introduction

9.01 The need to properly account for and report interfund, internal, and intra-entity activity and balances is unique to governmental financial reporting. The principal standards for classifying and reporting that activity and the resulting balances are in Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraphs 57 through 62 and 112, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraphs 14 and 15.¹ Additional guidance is presented in the GASB staff documents *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A) and *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A).

Nature of Transactions

Nature of Interfund Activity and Balances

9.02 Interfund activity is a resource flow within and among the three fund categories—governmental, proprietary, and fiduciary—and includes resource flows between a primary government and its blended component units.² (Paragraph 9.05 discusses activity and balances between a primary government and its discretely presented component units.) GASB Statement No. 34, paragraph 112, identifies two categories and four subcategories of interfund activity as follows:

- *Reciprocal interfund activity* is the internal counterpart to exchange and exchange-like transactions. There are two types of reciprocal interfund activity.
 - a. *Interfund loans* are amounts provided with a requirement for repayment.
 - b. *Interfund services provided and used* are purchases and sales of goods and services between funds for a price approximating their external exchange value. This includes most internal service fund activity.

¹ Governments that are required to apply GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, for financial statements for periods beginning after June 15, 2001 (phase 1 governments) are not required to apply these provisions of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, until financial statements for periods beginning after June 15, 2002, although earlier application is encouraged. (See paragraphs 9.13 and 9.14.)

² GASB Statement No. 34 provides that component units that are fiduciary in nature are displayed with fiduciary funds in the fiduciary fund financial statements. Those component units are treated the same as fiduciary funds and are therefore referred to in this Guide as fiduciary funds.

- *Nonreciprocal interfund activity* is the internal counterpart to nonexchange transactions. There are two types of nonreciprocal interfund activity.
 - a. *Interfund transfers* are flows of assets between funds without equivalent flows of assets in return and without a requirement for repayment. This includes payments in lieu of taxes (PILOTs) that are not payments for, and are not reasonably equivalent in value to, services provided. (Some governments characterize PILOTs as interfund services provided and used; see paragraph 9.30.)
 - b. *Interfund reimbursements* are repayments from the funds responsible for particular expenditures or expenses to the funds that initially paid for them.

Interfund balances arise from unpaid interfund activity. See the detailed discussion of interfund activity and balances at paragraphs 9.06 through 9.15.

9.03 Internal service funds are one source of interfund activities and balances. GASB Statement No. 34, paragraph 68, states that internal service funds may be used to report any activity that provides goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost-reimbursement basis. Internal service funds should be used only if the reporting government is the predominant participant in the activity.

Nature of Internal Activity and Balances

9.04 In the government-wide financial statements, internal activity and balances relate to interfund activity and balances reported in the fund financial statements. GASB Statement No. 34, paragraph 57, states “In the process of aggregating data for the statement of net assets and the statement of activities, some amounts reported as interfund activity and balances in the funds should be eliminated or reclassified.” See the detailed discussion of internal activity and balances at paragraphs 9.16 through 9.20.³

Nature of Intra-Entity Activity and Balances

9.05 Activity between primary governments and their discretely presented component units is known as intra-entity activity. Because of the separate nature of discretely presented component units, GASB Statement No. 34, paragraph 61, requires that activity between a primary government and its discretely presented component units be reported as if it relates to external transactions. See the detailed discussion of intra-entity activity and balances at paragraph 9.21.

Accounting and Financial Reporting Considerations^{4, 5}

Reporting Interfund Activity and Balances

9.06 National Council on Government Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraphs 57

³ Chapter 2, “Financial Reporting,” discusses how internal service fund assets and liabilities that are not eliminated in the government-wide statement of net assets generally should be reported in the governmental activities column.

⁴ Making disclosures for discretely presented component units is a matter of professional judgement, as discussed in Chapter 3, “The Financial Reporting Entity.”

⁵ The discussion in paragraph 9.22 on differing year ends between a primary government and its component units affects the discussions on interfund, internal, and intra-entity activity and balances.

and 75, states that interfund transfers should be recognized in the period in which the interfund receivable and payable arise. The recognition and measurement standards for several types of interfund activity—such as risk financing activities, pension plan contributions, and nonexchange transactions and lease agreements between a primary government and its blended component units—are discussed in Chapter 6, “Revenues and Receivables;” Chapter 8, “Expenses/Expenditures and Liabilities;” and Chapter 12, “Special Purpose and State Governments.” Interfund movements of capital assets are discussed in Chapter 7, “Capital Assets.”

9.07 Table 9.1 summarizes the required reporting in the funds for the four types of interfund activity and balances, as discussed further in this section.

Table 9.1

Interfund Activity and Balances: Required Reporting

<i>Type of Interfund Activity/Balances</i>	<i>Financial Reporting</i>
Interfund loans	Generally, interfund receivables/payables (see paragraph 9.08)
Interfund services provided and used	Generally, revenues and expenditures/expenses (see paragraph 9.09)
Interfund transfers	Other financing sources/uses or after nonoperating revenues/expenses (see paragraph 9.10)
Interfund reimbursements	Expenditures/expenses only in the funds responsible for them (see paragraph 9.11)

9.08 Lender funds should report interfund loans as interfund receivables while borrower funds should report them as interfund payables. If repayment is not expected within a reasonable time, the interfund balances should be reduced, and the lender fund should report a transfer to the borrower fund for the amount that is not expected to be repaid within a reasonable time, regardless of the basis of accounting used in the fund financial statements. As discussed in item 227 of the GASB 34 Q&A, there is no precise definition of the “expected within a reasonable time” provision, and professional judgment will determine whether an interfund loan should be reclassified. However, that item also discusses the notions of “expectation” and “reasonable time.” (See also paragraph 9.29.)

9.09 Interfund services provided and used should be reported as revenues in seller funds and expenditures or expenses in purchaser funds. However, when the general fund is used to account for risk-financing activity, GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended, requires interfund charges to other funds to be accounted for as interfund transfers (which are discussed in paragraph 9.10) or as interfund reimbursements (which are discussed in paragraph 9.11), depending on the circumstances. (See the discussion of accounting for risk financing activities in Chapter 8.)

9.10 In governmental funds, interfund transfers should be reported as other financing uses in the transferor funds and other financing sources in the recipient funds. In proprietary funds, transfers should be reported after nonoperating revenues and expenses.

9.11 Interfund reimbursements should reduce the expenditures or expenses in the funds that originally paid them and increase expenditures or expenses in the funds responsible for them. Consequently, reimbursements are not displayed as interfund activity in the financial statements.

9.12 Unpaid amounts arising from interfund activity should be reported as interfund receivables and payables in the fund financial position statements, except as discussed in paragraph 9.08 for loans for which repayment is not expected within a reasonable time. NCGA Statement 1, footnote 5, states that where money is owed from one fund to another fund, and money is also owed from the latter to the former, the amounts receivable and payable should not be offset in the accounts. However, for purposes of reporting, that Statement provides that current amounts due from and due to the same funds may be offset and the net amounts shown in the respective fund financial position statements.

9.13 GASB Statement No. 38, paragraph 14, requires the notes to the financial statements to disclose amounts due from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type. Governments also should disclose the purpose for interfund balances and interfund balances that are not expected to be repaid within one year from the date of the financial statements.⁶

9.14 GASB Statement No. 38, paragraph 15, requires the following disclosures about interfund transfers reported in the fund financial statements:⁷

- Amounts transferred from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type
- A general description of the principal purposes of the government's interfund transfers
- The intended purpose and the amount of significant transfers that meet either or both of the following criteria: (a) do not occur on a routine basis or (b) are inconsistent with the activities of the fund making the transfer

9.15 If a government chooses to use an internal service fund to account for its risk financing activities, GASB Statement No. 10, as amended, provides guidance. The Statement generally provides that the total charge by the internal service fund to the other funds be based on an actuarial method or historical cost information and adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal. That guidance applies even though the fund may periodically report annual deficits or accumulated fund balance deficits. If the government cannot recoup such deficits over a reasonable period of time, however, the internal service fund deficit should be charged back to the user funds. For risk financing internal service funds, GASB Statement No. 10, paragraph 67, as amended, requires disclosure in the notes to the financial statements of (a) deficit fund balances and (b) designations of net assets for net assets resulting from

⁶ See footnote 1. Phase 1 governments that do not apply this provision of GASB Statement No. 38 continue to be required by NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 158, and NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4, to disclose information about interfund receivables and payables.

⁷ See footnote 1.

charging a reasonable provision for expected future catastrophe losses. (See Chapter 8 for additional discussion of the accounting and financial reporting requirements for risk financing, including when using internal service funds.)

Reporting Internal Balances and Activity

9.16 In the government-wide statement of net assets, some internal balances are reclassified or eliminated to minimize the “grossing up” effect on net assets and liabilities within the governmental and business-type activities, including:

- a. Amounts owed between the funds included in the governmental activities column are eliminated (that is, not reported in the statement of net assets), as are amounts owed between funds included in the business-type activities column. This includes interfund receivables and payables relating to internal service fund activity.
- b. Amounts owed between governmental and business-type activities are presented as internal balances. However, those internal balances are ultimately eliminated in the “total primary government” column. As shown in the illustrative financial statements in the nonauthoritative Appendix C of GASB Statement No. 34, this is done either by (1) including both the receivable and payable on the same financial statement line as “internal balances” (reported with either assets or liabilities) that offset each other in the aggregation process or (2) adjusting the amounts out of the “total primary government” column, accompanied by a notice of the elimination.
- c. Amounts of receivables and payables between the primary government and fiduciary funds are reported as receivable from and payable to external parties, as required by GASB Statement No. 34, paragraph 58, rather than as internal balances.

9.17 Table 9.2 summarizes the required reporting in the government-wide financial statements for internal balances.

Table 9.2

Internal Balances Reporting in Government-Wide Financial Statements

<i>Nature of Balance</i>	<i>Reporting</i>
Between funds included in governmental activities column	Eliminate within the governmental activities column
Between funds included in business-type activities column	Eliminate within the business-type activities column
Between a fund included in governmental activities column and a fund included in the business-type activities column	Internal balance; eliminate in the total primary government column
Between the primary government and fiduciary funds	Report as receivable from/payable to external parties

9.18 Interfund transfers within governmental activities and within business-type activities should be eliminated and not presented in the statement of activities. Only the net amount transferred between governmental and business-type activities should be reported in the statement of activities, but

that amount ultimately should be eliminated in the “total primary government” column. The GASB 34 Q&A, item 154, indicates that the elimination can be achieved by combining all transfers in and transfers out within the separate governmental and business-type activities columns into a single line item on the statement of activities.

9.19 GASB Statement No. 34, paragraphs 59 and 60, provides the following additional guidance concerning eliminations of internal activity in the government-wide statement of activities:

- a. Internal service fund activity is eliminated to remove the “doubling-up” effect. For example, suppose an internal service fund that is reported as governmental activities has revenues and expenses of \$10,000 relating to sales to governmental funds. In determining the amount of revenues and expenses of government activities in the statement of activities, the aggregate fund revenues and expenses would be reduced by \$10,000. Further, the GASB 34 Q&A, item 147, indicates that eliminating the “effect” of internal service fund activity requires preparers to “look back” and adjust the internal service fund’s internal charges to break even. That is, internal service fund net income from internal activity (the amount by which revenues exceeds expenses) would cause a pro rata reduction in the charges made to the participating functions or programs. Conversely, an internal service fund net loss would require a pro rata increase in the amounts charged to the participating functions or programs. A nonauthoritative exercise in the GASB 34 Q&A provides an example of eliminating the effect of internal service funds.
- b. Internal events that are in effect allocations of overhead expenses between and within functions are eliminated so the allocated expenses are only reported by the function to which they were allocated. However, the GASB 34 Q&A, item 151, indicates that, for practical reasons, elimination of internal activity within a single function (activity that has no effect on the net [expense] revenue of the function) is not necessary unless the effect on direct expenses or program revenues is material. That practical explanation does not change the standard for the elimination of internal activity within a single function, but rather recognizes the application of materiality considerations. A government that does not eliminate internal activity with a single function because it is following the “practical” approach should be able to demonstrate that the effect does not materially misstate the components of the net expense or net revenue of the function.
- c. Amounts relating to interfund services provided and used between functions are not eliminated.

9.20 GASB Statement No. 34, paragraph 115c, requires governments to disclose their policy for eliminating internal activity in the government-wide statement of activities. Item 114 in the 2nd GASB 34 Q&A discusses the possible content of that required disclosure.

Reporting Intra-Entity Activity and Balances

9.21 Loans and repayments between the primary government and its discretely presented component units should affect only the statement of net

assets. Other intra-entity activity should be reported as revenues and expenses. Intra-entity receivables and payables should be reported on a separate line. See also the guidance in Chapters 6 and 8, including the guidance on nonexchange transactions, and the guidance in Chapter 12 on lease agreements between primary governments and their component units.

Differing Year Ends

9.22 When a component unit's fiscal year differs from that of its primary government, internal activity and balances may not be fully eliminated in the government-wide financial statements, and interfund and intra-entity activity and balances may not equal. GASB Statement No. 14, *The Financial Reporting Entity*, paragraph 60, as amended, requires that if transactions between component units that have different fiscal years result in inconsistencies in amounts reported as due to or due from and so forth, the government should disclose the nature and amount of those transaction in the notes to the financial statements.

Auditing Considerations

9.23 The audit objectives for interfund, internal, and intra-entity activity and balances are as follows:

- *Existence or Occurrence.* All recorded interfund, internal, and intra-entity activity and balances are based on actual, valid activity between funds, activities, or the primary government and its component units.
- *Completeness.* All interfund, internal, and intra-entity activity and balances are identified, recorded, disclosed, and eliminated as appropriate.
- *Rights and Obligations.* All recorded interfund, internal, and intra-entity activity and balances are in accordance with budget, legislative, or management authorizations that have a direct and material effect on the determination of financial statement amounts.
- *Valuation or Allocation.* Interfund, internal, and intra-entity activity and balances are recorded at the proper amounts.
- *Presentation and Disclosure.* Interfund, internal, and intra-entity activity and balances are properly classified and internal activity and balances are properly eliminated. Financial statement presentation and disclosure are in conformity with GAAP consistently applied.

9.24 A government's interfund, internal, and intra-entity activity and balances often are subject to various compliance requirements. Although a government should be concerned with all compliance requirements, generally accepted auditing standards (GAAS) focus the auditor's concern on compliance requirements that have a direct and material effect on the determination of financial statement amounts. See the further discussion of the auditor's responsibility in this regard in Chapter 4, "Planning the Audit."

9.25 The auditor needs to determine that adequate procedures are performed related to each of those opinion units with material interfund, internal, and intra-entity activity and balances. (See the discussion of opinion units in Chapter 4.) The auditor should obtain an understanding of the government's internal control over interfund, internal, and intra-entity activity and balances. Internal control features related to that activity may include the following:

- Legislative or budgetary authorization for the activities
- A process to ensure that the activities are properly authorized and in accordance with budgetary authorization before they are initiated, including periodic supervisory review
- Policies and procedures to ensure that the activities are properly recorded and classified in the accounting records, including that they are properly identified as interfund or intra-entity activities
- Processes to ensure that internal service fund charges are appropriate and conform with GAAP
- Policies and procedures to periodically review outstanding interfund loans for reclassification as interfund transfers
- Policies and procedures to ensure that the activities are presented and disclosed in the financial statements in conformity with GAAP, including processes to make appropriate eliminations and reclassifications for internal activity and balances in the government-wide financial statements

9.26 Audit procedures relating to interfund, internal, and intra-entity activity and balances may include:

- Reviewing minutes of the governing body, adopted budget, appropriate debt issuance documents, and other legal and contractual provisions for authorization of the activities and for any restrictions that could have a direct and material effect on the determination of financial statement amounts
- Examining a sample of activities to ensure they are appropriately authorized, within budget, properly recorded in the accounting records, and appropriately reported and classified in the financial statements
- Reviewing interfund and intra-entity balances for age, anticipated liquidation method, and collectibility
- Evaluating whether internal service fund charges are appropriate and conform with GAAP
- Reviewing and analyzing the entity's eliminations and reclassifications of internal activity and balances in the government-wide financial statements, including those for internal service fund and similar cost allocation activities
- Determining whether (a) interfund receivables equal interfund payables and whether transfers in equal transfer out, (b) internal activity and balances are fully eliminated in the government-wide financial statements, and (c) amounts of intra-entity activity and balances are consistent between the primary government and its discretely presented component units and between those component units (These conditions may be affected by differing fiscal year ends between the primary government and its component units and between component units.)
- Determining whether the entity's note disclosures relating to the activities and balances are complete and presented in conformity with GAAP

9.27 A government's accounting systems, processes, and records may not provide sufficient information about interfund activities to enable the government to report interfund activity and balances in the fund financial statements or to eliminate internal activity and balances in the government-wide financial statements in conformity with GAAP. The auditor should evaluate whether the

GAAP departure is material to one or more opinion units. If the auditor is unable to quantitatively or qualitatively assess the materiality of the GAAP departure, the auditor should consider whether the scope limitation imposed by that missing information is of a sufficient magnitude that the auditor's opinion on the financial statements of one or more opinion units will be affected.

9.28 An internal service fund is operated on a cost-reimbursement basis. Cost is most often interpreted as all expenses, including capital costs. For an internal service fund to operate on a cost-reimbursement basis, its charges to other funds should result in revenues and expenses that are approximately equal over time, even though it periodically may report annual increases or decreases in net assets. Because the intent of internal service funds is to facilitate cost allocation, the accumulation of net asset surpluses or deficits over time generally⁸ indicates that service is no longer being made on a cost-reimbursement basis, and the auditor should consider evaluating whether the activity continues to qualify for reporting in an internal service fund. Further, grantors often require that grantees allocate internal service fund costs to grant programs using the same methodology they use to allocate costs internally. Surpluses in internal service funds could lead a grantor to seek a recovery. The auditor should consider evaluating the effect that compliance requirements have on internal service fund charges made to grant programs and on surpluses in those funds. (Chapter 4 discusses the auditor's responsibility for financial statement misstatements arising from illegal acts.)

9.29 As discussed in paragraph 9.08, interfund loans include only amounts that are expected to be repaid within a reasonable time. The GASB has left the judgment of what constitutes "the expectation of a reasonable time" to financial statement preparers and auditors. When a government reports interfund loans, the auditor should consider evaluating whether the borrowing fund has both the ability and intent to repay within a reasonable time. In evaluating a fund's ability to repay the interfund loan within a reasonable time, the auditor may consider factors such as the fund's current financial position and estimates of future resources. In evaluating the intent to repay, the auditor may consider factors such as the purpose of the loan, the established repayment terms, the loan's current status, and management's representations.

9.30 Some governments characterize payments between funds as services provided and used when the payments are reasonably equivalent in value to the services provided. Those payments may be referred to by different terms, but when they involve enterprise funds, the payments sometimes are referred to as PILOTs. The government should have documentation supporting its conclusion that the payment is reasonably equivalent in value to the services provided for the payment to be characterized as services provided and used. The auditor should consider evaluating whether the documentation supports the government's conclusion. A government's failure to provide support for its conclusion limits the auditor's ability to evaluate whether the appropriate accounting has been applied in the preparation of the basic financial statements. That is a scope limitation that the auditor evaluates in developing his or her opinions on the basic financial statements.

⁸ GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 67, does not require that deficits, if any, in a risk financing internal service fund that result from certain pricing methods be charged back to the other funds in any one year, as long as adjustments are made over a reasonable period of time. See the further discussion in paragraph 9.15 and Chapter 8, "Expenses/Expenditures and Liabilities."

Transition to GASB Statement No. 34

9.31 GASB Statement No. 34 changed the terminology used to refer to interfund activity, which previously was termed *interfund transactions*. Table 9.3 is a crosswalk between the previous terms and those used in GASB Statement No. 34.

Table 9.3

Changes in Interfund Terminology

<i>Before GASB Statement No. 34</i>	<i>GASB Statement No. 34</i>
Quasi-external transactions	Interfund services provided and used ⁹
Reimbursements	Interfund reimbursements
Residual equity transfers	Interfund transfers
Operating transfers	Interfund transfers
Interfund loans	Interfund loans
Intra-entity transactions and balances	Intra-entity activity and balances

9.32 Previous GAAP required residual equity transfers to proprietary funds to be reported in a “contributed capital” component of equity. The transition section of Chapter 10, “Equity and Financial Statement Reconciliations,” discusses how GASB Statement No. 34 changes the equity presentation of proprietary funds, including eliminating contributed capital.

⁹ The GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (GASB 34 Q&A), item 102, explains that interfund services provided and used are narrower than quasi-external transactions. This is because the amounts of interfund services provided and used should approximate their external exchange value; no such restriction applied to quasi-external transactions, which also included nonexchange transactions.

Chapter 10

Equity and Financial Statement Reconciliations

Nature of Transactions

10.01 Generally accepted accounting principles (GAAP) have unique provisions for the display of equity¹ in governmental financial statements. The principal Governmental Accounting Standards Board (GASB) pronouncements that address the display of equity are National Council on Government Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, and GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. Depending on the financial statements involved, equity is displayed based on restrictions on the use of the related resources or on reservations that affect the budgetary process.

10.02 The equity reported in governmental financial statements changes only as a result of (a) changes in equity reported in the associated activity statement, (b) prior-period adjustments, including changes in accounting principles that are applied retroactively,² changes in the financial reporting entity, and corrections of an error, and (c) changes in governmental funds inventories that are accounted for using the purchases method. Otherwise, no amounts are reported in the financial statements as direct changes to equity. Further, total equity does not change as a result of changes in the composition of the components of equity.

10.03 The totals and subtotals of equity and changes in equity reported in the various financial statements might differ from the amounts reported in the other financial statements because of the scope of activities reported and the measurement focus and basis of accounting (MFBA) used. Therefore, GASB Statement No. 34 requires certain summary reconciliations between the amounts reported in the various financial statements.

Financial Reporting Considerations

10.04 This section discusses various standards relating to the presentation of equity and its components in the various financial statements and the related note disclosures. It also discusses the required financial statement reconciliations. Additional guidance is provided in the GASB staff documents *Guide to Implementation of GASB Statement No. 34 on Basic Financial*

¹ The term *equity* is used throughout this chapter as a generic term to refer to the difference between assets and liabilities. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires the use of different titles to report the equity in different financial statements as discussed later in this chapter.

² See the discussion in Chapter 2, "Financial Reporting," on the application of Accounting Principles Bulletin (APB) Opinion No. 20, *Accounting Changes*, as amended, in the proprietary fund and government-wide financial statements.

Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers (GASB 34 Q&A) and *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A).

Government-Wide Net Assets

10.05 Paragraphs 32 through 37 of GASB Statement No. 34 require the equity reported in the government-wide statement of net assets to be labeled *net assets* and to be displayed in three components: “invested in capital assets, net of related debt,” “restricted,” and “unrestricted.” The following explains each:

- *Invested in capital assets, net of related debt* consists of capital assets, including restricted capital assets, reduced by accumulated depreciation and by any outstanding debt incurred to acquire, construct, or improve those assets. If there are significant unspent proceeds of capital-related debt at year-end, this component does not include the portion of the debt attributable to those proceeds. Instead, that debt is placed in the net assets component that includes the unspent proceeds, for example, “restricted for capital projects.”
- *Restricted net assets* reports those net assets³ with limits on their use that are externally imposed (by creditors, grantors, contributors, or the laws or regulations of other governments) or that are imposed by the government's own constitutional provisions or enabling legislation. The GASB 34 Q&A, item 95, discusses how, for this purpose, *enabling legislation* authorizes the government to mandate the payment of resources from external resource providers and includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation. Footnote 25 of GASB Statement No. 34 states that *enabling legislation* also includes restrictions established by a governmental utility's own governing board when that utility's financial statements are based on Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation*. Separate line items should distinguish among major categories of restrictions. When permanent endowments or permanent fund principal amounts are included in this component, “restricted net assets” are displayed in two subcomponents: expendable and nonexpendable.⁴ GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, paragraph 22, requires that net assets that result from endowments and similar transactions be reported as restricted for as long as the provider's purpose restrictions or time requirements remain in effect.

³ The GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A), item 99, indicates that the restricted component of net assets represents both restricted assets and liabilities related to those assets. The nonauthoritative exercise 3 in the GASB 34 Q&A states that “a liability ‘relates to’ restricted assets if the asset results from incurring the liability or if the liability will be liquidated with the restricted assets. No category of restricted net assets can be negative—that is, if liabilities that relate to restricted assets exceed those assets, no balance should be reported; the negative amount should be reported as a reduction of unrestricted net assets.”

⁴ Nonexpendable net assets are those that are required to be retained in perpetuity. The GASB 34 Q&A, item 98, clarifies that this display requirement does not apply to term endowments. The objective of the display requirement is to identify net assets that cannot be spent. Term endowments may “currently” be nonexpendable, but at some point in the future (when the term expires) they will become expendable.

- *Unrestricted net assets* consists of all net assets that do not meet the definition of either of the other two components.

Designations of net assets, which represent management intentions for the use of resources, should not be reported in the statement of net assets. However, GASB Statement No. 34 does not prohibit governments from disclosing those designations in the notes to financial statements.

10.06 The illustrative financial statements in a nonauthoritative appendix of GASB Statement No. 34 present the display of the equity section of the government-wide statement of net assets as shown in Table 10.1.

Table 10.1

Equity of Government-Wide Financial Statements

	<i>Primary Government</i>			<i>Component Units</i>
	<i>Governmental Activities</i>	<i>Business Activities</i>	<i>Total</i>	
Invested in capital assets, net of related debt	XXX,XXX	XXX,XXX	XXX,XXX	XX,XXX
Restricted for:				
Capital projects	XX,XXX	—	XX,XXX	XXX
Debt service	X,XXX	X,XXX	X,XXX	—
Community development projects	X,XXX	—	X,XXX	—
Other purposes	X,XXX	—	X,XXX	—
Unrestricted	(X,XXX)	XX,XXX	X,XXX	X,XXX
Total net assets	<u>\$XXX,XXX</u>	<u>\$ XX,XXX</u>	<u>\$XXX,XXX</u>	<u>\$XX,XXX</u>

10.07 The amount of net assets reported for a primary government in the government-wide financial statements usually will differ from the aggregate amount of equity reported in its fund financial statements. One reason for this difference is that the government-wide financial statements use a different MFBA than do the governmental fund financial statements. The other reason for this difference is that the government-wide financial statements do not include the amounts reported in the fiduciary fund financial statements. (See paragraphs 10.19 through 10.21.)

Proprietary Fund Net Assets (or Fund Equity)

10.08 GASB Statement No. 34, footnote 40, requires the equity reported in the proprietary fund statement of net assets or balance sheet to be labeled either *net assets* or *fund equity*. GASB Statement No. 34, paragraph 98, requires that equity be displayed using the three net asset components discussed in paragraph 10.05. (See also Table 10.1.) Equity balances resulting from capital contributions and designations of net assets should not be displayed as such in the proprietary fund statement of net assets or balance sheet.

Governmental Fund Balances

10.09 GASB Statement No. 34, paragraphs 83 and 84, requires the equity reported in the governmental fund balance sheet to be labeled *fund balances* and to be segregated into reserved and unreserved amounts.

10.10 As provided in NCGA Statement 1, fund balance reserves report the portions of the fund balances that are (a) legally segregated for a specific use (for example, contractual commitments to third parties that are not liabilities at the balance sheet date),⁵ or (b) not appropriable for expenditure because the underlying asset is not a financial resource available for current appropriation or expenditure (for example, inventories, prepaid items, noncurrent receivables that are not offset by deferred revenue, and the noncurrent portion of interfund receivables). GASB Statement No. 34, paragraph 84, requires reserved fund balances of nonmajor governmental funds to be displayed in sufficient detail to disclose the purposes of the reservations.

10.11 GASB standards do not describe the characteristics of legal provisions that should result in reporting reserves as opposed to designations of fund balance. Some governments report fund balance reserves for legal provisions based on the guidance in GASB Statement No. 34 for reporting restricted net assets in the government-wide statement of net assets (see paragraph 10.05). Other governments contend that the guidance for reporting restricted net assets does not apply to fund balance reserves arising from legal provisions—even by analogy. Therefore, they report fund balance reserves even for legal provisions that would not result in reporting restricted net assets.

10.12 The GASB 34 Q&A, item 200, indicates that fund balance reserves would not be reported if resources that are legally segregated for a specific future use are reported in a separate fund used only for that purpose. The use of the separate fund itself communicates the legal segregation for a specific future use.

10.13 Encumbrances (discussed in Chapter 11, “The Budget”) represent commitments related to unperformed contracts for services and undelivered goods. If encumbered appropriations do not legally lapse, the amount of encumbrances outstanding at year-end is reclassified from unreserved fund balance to a reserve for encumbrances to demonstrate future contractual claims against the fund balance.

10.14 Governments are permitted to report reserves for inventories and prepaid items that are accounted for using the consumption method. The intent of reporting those reserves is to demonstrate the extent to which the fund balance is composed of resources that are not available for other discretionary expenditures. If a government uses the purchases method to account for inventories, it should report a reserve for those inventories and should display the change in the reserve as a change to beginning fund balance.

10.15 Restricted net assets for governmental activities in the government-wide statement of net assets generally will differ from amounts that are reported as reserved fund balances in the governmental fund balance sheet. Although the terms *reserved* and *restricted* appear similar, their meanings in a governmental financial reporting context differ significantly. As discussed in paragraph 392 of the nonauthoritative Basis for Conclusions of GASB Statement No. 34, *restricted* derives from external, legal constraints, whereas *reserved* is a function of the budgetary notion of “available for appropriation.” Reserved fund balances may include more than resources that are restricted. For example, governmental funds report resources reserved for inventories, but those amounts are not reported as restricted in the government-wide financial statements. (The GASB 34 Q&A includes a nonauthoritative exercise

⁵ GASB Statement No. 33, footnote 13, requires that fund balances that result from endowments and similar transactions be reported as a reservation for as long as the provider's purpose restrictions or time requirements remain in effect.

that illustrates how fund balances of governmental funds are converted to the required components of net assets in the government-wide financial statements.)

10.16 The fund balances that remain after reservations are unreserved fund balances. GASB Statement No. 34, paragraph 84, requires unreserved fund balances of the nonmajor governmental funds to be displayed by fund type.

10.17 Governments also may establish fund balance designations. Designated fund balances indicate tentative management plans for the future use of financial resources. Such planned uses may never be legally authorized or result in expenditures. Examples of designations are amounts earmarked for next year's budget appropriations, to complete capital projects, and for unknown contingent liabilities. Generally, designations are supported by definitive plans and approved by the government's senior management. NCGA Statement 1, paragraph 120, requires fund balance designations to be reported as part of unreserved fund balances and to be displayed as separate line items or parenthetically on the balance sheet or disclosed in the notes to the financial statements. Designations should not result in reporting negative undesignated balances in the financial statements at year-end, regardless of the amount of undesignated fund balance at the time the designation was made. The unreserved fund balances that remain after designations are undesignated fund balances.

10.18 The illustrative financial statements in a nonauthoritative appendix of the GASB 34 Q&A present the display of the equity section of the governmental fund balance sheet as shown in Table 10.2. Designations of fund balances may be included in the display or disclosed in the notes to the financial statements.

Table 10.2

Equity Section of Governmental Funds Balance Sheet

	<i>General</i>	<i>HUD Programs</i>	<i>Community Redevelop- ment</i>	<i>Route 7 Construc- tion</i>	<i>Other Govern- mental Funds</i>	<i>Total Govern- mental Funds</i>
Fund balances:						
Reserved for:						
Inventories	XXX	—	—	—	—	XXX
Noncurrent receivables	XXX	—	—	—	—	XXX
Encumbrances	XX	XX	XXX	X,XXX	X,XXX	X,XXX
Debt service	—	—	—	—	X,XXX	X,XXX
Other purposes	—	—	—	—	X,XXX	X,XXX
Unreserved:	XXX	X,XXX	XX,XXX	X,XXX		XX,XXX
Unreserved, reported in nonmajor:						
Special revenue funds	—		—	—	X,XXX	X,XXX
Capital projects funds	—	—			X,XXX	X,XXX
Total fund balances	X,XXX	X,XXX	XX,XXX	X,XXX	X,XXX	XX,XXX

Reconciliations—Equity and Changes in Equity

10.19 As discussed in paragraph 10.07, the amount of net assets reported for a primary government in the government-wide statement of net assets usually will differ from the aggregate amount of equity reported in its fund financial position statements. Similarly, there will be differences between the changes in equity reported in the various activity statements. To explain those differences, GASB Statement No. 34, paragraph 77, requires summary reconciliations to the government-wide financial statements to be presented at the bottom of the fund financial statements or in an accompanying schedule. The GASB 34 Q&A, item 190, explains that if an accompanying schedule is used, it should be considered a continuation of the fund financial statement and therefore be presented immediately following the statement it supports. Generally, brief explanations on the face of the financial statements suffice. However, governments should provide more detail in the notes to the financial statements if aggregated information in the summary reconciliation on the financial statements obscures the nature of individual elements of a particular reconciling item.

10.20 For governmental funds, GASB Statement No. 34 requires total governmental fund balances to be reconciled to the net assets of governmental activities. It also requires the total changes in the governmental fund balances to be reconciled to the change in net assets of governmental activities. Typical differences that require reconciliation include equity and changes in equity arising from capital assets, revenues that are deferred because they are not “available,” and long-term liabilities (including debt issuances and repayments) as well as the residual assets and liabilities of internal service funds (which, as discussed in Chapter 2, “Financial Reporting,” generally are reported with governmental activities in the government-wide financial statements).

10.21 For enterprise funds, (a) total enterprise fund net assets should be reconciled to the net assets of business-type activities and (b) the total change in enterprise fund net assets should be reconciled to the change in net assets of business-type activities provided there are differences that require reconciliation. GASB Statement No. 34, paragraph 104, states that generally there are no reconciling items between the enterprise funds and business-type activities. That is, the amounts reported as total enterprise fund net assets and changes in net assets usually are the same as net assets and changes in net assets of business-type activities. However, there may be differences that require reconciliation. For example, in the process of eliminating internal service fund activities for the statement of activities, some of the fund’s net income or loss may be allocated to business-type activities. Also, the residual assets and liabilities of internal service funds are reported with business-type activities in certain situations. Further, the GASB 34 Q&A, items 106 and 218, indicates that differences may arise from (a) allocating indirect costs from governmental activities to business-type activities and (b) reporting enterprise funds with governmental activities or governmental funds with business-type activities.

Fiduciary Fund Net Assets

10.22 GASB Statement No. 34, paragraph 108, requires the equity reported in the fiduciary fund statement of fiduciary net assets to be labeled *net assets* but does not require net assets to be displayed in the net asset components as discussed in paragraph 10.05. Specific display requirements for pension and other employee benefit trust funds and investment trust funds in

GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*; No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*; and No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, require net assets to be labeled to indicate the purpose for which they are held. For example, GASB Statement No. 25, paragraph 27, requires the use of the caption “net assets held in trust for pension benefits.” In a nonauthoritative appendix, GASB Statement No. 34 illustrates the single net asset line item for both a pension trust fund and a private-purpose trust fund as net assets “held in trust for pension benefits and other purposes.”

Note Disclosures

10.23 The following disclosures are among those that GASB standards require about equity if the information is not apparent on the face of the financial statements.⁶

- Deficit fund balances or net assets of individual funds (NCGA Interpretation 6, *Notes to the Financial Statements*, paragraph 4, as amended)
- Fund balance designations for governmental funds (NCGA Statement 1, paragraph 120)
- The government’s policy regarding whether to first apply restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available (GASB Statement No. 34, paragraph 115)
- Detailed explanations of reconciliations between the fund and government-wide financial statements (See paragraph 10.19.)

Auditing Considerations

10.24 The audit objectives for equity, categorized by financial statement assertion, are as follows:

- *Existence or occurrence.* All changes in equity and its components are based on actual transactions or other events and, where applicable, properly authorized.
- *Completeness.* All equity components are identified, recorded, and disclosed.
- *Rights and obligations.* All equity components are accounted for in accordance with legal and contractual provisions that have a direct and material effect on the determination of financial statement amounts.
- *Valuation or allocation.* All equity components are reported at appropriate amounts.
- *Presentation and disclosure.* All equity components are properly classified and adequately disclosed. Financial statement presentation and disclosure are in conformity with GAAP consistently applied.

10.25 Items that are presented in the financial statement reconciliations result from recognition and scope differences between the financial statements. Consequently, audit objectives for the transactions underlying those

⁶ Making disclosures for discretely presented component units is a matter of professional judgment, as discussed in Chapter 3, “The Financial Reporting Entity.”

differences (for example, determining whether all expenses/expenditures and liabilities are identified, recorded, and disclosed in the government-wide financial statements and the fund financial statements) also represent audit objectives for the components of the reconciliations. However, an additional audit objective concerns presentation and disclosure—whether the reconciliations are presented and disclosed in conformity with GAAP consistently applied.

10.26 A government's equity accounts often are subject to various compliance requirements. Although a government should be concerned with all compliance requirements, generally accepted auditing standards (GAAS) focus the auditor's concern on compliance requirements that have a direct and material effect on the determination of financial statement amounts. See the further discussion of the auditor's responsibility in this regard in Chapter 4, "Planning the Audit."

10.27 The auditor needs to obtain appropriate audit evidence for each of those opinion units with material equity accounts. (See the discussion of opinion units in Chapter 4.) The nature, extent, and timing of audit procedures on the financial statement reconciliations would relate to the auditor's evaluation of materiality for the governmental and business-type activities opinion units in the government-wide financial statements. The reconciliations explain the differences between (a) the total governmental funds and the governmental activities and (b) the total enterprise funds and business-type activities. Therefore, the reconciliations are not designed to relate to opinion units in the fund financial statements (such as individual major governmental funds).

10.28 The auditor should obtain an understanding of the government's internal control over equity and its components and the financial statement reconciliations. In addition to standard internal control features for equity, internal control features for equity and for the financial statements reconciliations that are unique or significant in government may include the following:

- A process for identifying and documenting net asset restrictions and fund balance reserves and designations
- Review and approval of documentation for net asset restrictions and fund balance reserves and designations by appropriate personnel
- A process for identifying and authorizing the use of restricted, reserved, or designated resources
- Periodic review of restricted, reserved, or designated equity accounts
- A process for identifying, documenting, and reviewing reconciling items between the fund and the government-wide financial statements and for presenting those reconciliations in conformity with GAAP
- A process for identifying, documenting, and reviewing required note disclosures for equity

10.29 In addition to standard audit procedures for equity, audit procedures for equity and for the financial statements reconciliations that are unique or significant in government may include the following:

- Reviewing minutes of meetings of the governing body; constitution, charter, statutes, and ordinances; debt issuance documents; contribution and grant contracts; and other similar documents to identify the requirements and authorizations for equity restrictions and reserves
- Reviewing appropriate documentation to support fund balance designations
- Asking appropriate management personnel about the existence of equity restrictions, reserves, and designations

- Determining whether equity restrictions, reserves, and designations have been made in compliance with the applicable legal and contractual provisions and management policies and are properly disclosed in the financial statements
- Testing expenses/expenditures to determine that restricted, reserved, or designated resources are used (a) for their restricted, reserved, or designated purpose and (b) in accordance with management's policy regarding whether to first apply restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available
- Determining whether deficit fund balances or net assets of individual funds are properly disclosed in the financial statements
- Determining whether fund balance designations create or increase a negative undesignated fund balance at year-end
- Determining that fund balance designations represent future expenditure intentions rather than unperformed (executory) contracts that should be reported as a reserve for encumbrance
- Determining whether equity restrictions, reserves, and designations are removed if they are no longer required
- Analyzing changes to equity accounts for the year to determine whether they are properly reported in the financial statements or the notes thereto
- Evaluating whether the reconciling items between the fund and the government-wide financial statements are properly calculated and the reconciliations are properly presented

10.30 As discussed in Chapter 2, the standards for selecting major funds could result in different funds being reported as major each year. Further, as discussed in Chapter 4, the auditor should plan, perform, evaluate the results of, and report on the audit of each opinion unit and each major fund is a separate opinion unit. If the auditor did not audit a current-year major fund as major in the previous year, the auditor should consider the need to perform procedures on the opening equity balance of the fund to evaluate whether the equity amount is properly stated and supported by underlying assets and liabilities.

Transition to GASB Statement No. 34

10.31 Previous GAAP did not require governments to present government-wide financial statements. Transition to GASB Statement No. 34 will require a government to determine the amount of beginning net assets for presentation in its statement of activities.⁷ For many governments, that equity presentation will be affected by large amounts of assets and liabilities that previously have not had an equity effect and infrastructure assets that previously have not been reported.

10.32 Some governments may determine the amount of beginning net assets for presentation in the statement of activities by determining the beginning balances of individual asset and liability accounts. In that situation,

⁷ GASB Statement No. 34 does not require the retroactive effect of certain FASB and GASB standards to be considered in determining beginning net assets for governmental activities. See the discussion in the transition section of Chapter 2, "Financial Reporting."

auditors should perform appropriate procedures on the beginning asset, liability, and net assets accounts to determine that beginning net assets (and amounts presented for prior periods, if any) are properly stated. Other governments may determine the amount of beginning net assets simply by calculating the difference between ending net assets and the change in net assets for the period, rather than by calculating beginning balances for individual asset and liability accounts. In that situation, the auditor should perform appropriate procedures to evaluate whether the amount of net assets is properly stated and supported by underlying assets and liabilities.

10.33 In some situations a government will have to restate beginning fund balances or fund net assets in its fund financial statements when it implements GASB Statement No. 34. This would occur, for example, if the government (a) did not previously apply GAAP, (b) is adjusting its fund structure because of GASB Statement No. 34 requirements (such as moving an activity from a special revenue fund to an enterprise fund), or (c) is concurrently implementing other accounting standards that result in recognition or measurement changes (such as GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*). In such situations, an auditor should consider performing procedures to support a conclusion whether the restatement and its presentation are in conformity with GAAP.

10.34 Previous GAAP required the presentation of proprietary fund equity in two components—contributed capital and retained earnings. GASB Statement No. 34 replaces that presentation with the three components of net assets. Transition to GASB Statement No. 34 does not require a government to restate the components of beginning equity in the proprietary fund financial statements (unless the government presents prior-year financial statements and restatement of those prior-year financial statements is practical). Instead, the government will total the previously presented contributed capital and retained earnings as beginning net assets or fund equity.

Chapter 11

The Budget

Introduction

11.01 Budgeting is an essential element of the financial planning, control, and performance evaluation processes of many governments. In contrast to commercial organizations' planning-oriented budgetary practices, governments usually adopt budgets that have the force of law, are subject to sanctions for overspending budgetary authorizations, and have extensive controls to ensure budgetary compliance. The budgeting requirements and practices followed by governments vary greatly, and the auditor should be knowledgeable about the laws and regulations governing the budgetary requirements of the government being audited, as well as the government's budget and budgetary process. In addition to basic information about the budgetary process, this chapter discusses:

- The financial reporting requirements relating to budgetary comparison information
- The auditor's responsibility for required budgetary comparison information, whether presented as required supplementary information (RSI) or as part of the basic financial statements
- How performing audit procedures on an entity's budget may assist in the audit of financial statement accounts or be required to satisfy the auditor's responsibility for material misstatements arising from illegal acts

11.02 State laws and regulations generally require general-purpose and some special-purpose governments to adopt budgets and to report on their actual results against those budgets for at least their general funds. Legal provisions also may require those entities to adopt and report on budgets for other funds, such as special revenue and debt service funds. Some governments, in particular special-purpose governments such as utilities, authorities, and colleges and universities, do not have legal provisions that require budgets or budgetary reporting, and they may not have legally adopted budgets, which are budgets that create legally enforceable limits on spending.

11.03 National Council on Government Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*; NCGA Interpretation 10, *State and Local Government Budgetary Reporting*; and Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, are the primary standards for budgetary accounting and reporting. In NCGA Statement 1, as amended, the summary statement of principle regarding budgeting, budgetary control, and budgetary reporting states the following:

- a. An annual budget(s) should be adopted by every governmental unit.
- b. The accounting system should provide the basis for appropriate budgetary control.

- c. Budgetary comparison schedules should be presented as RSI for the general fund and for each major special revenue fund that has a legally adopted annual budget.¹ The budgetary comparison schedules should present both (1) the original and (2) the final appropriated budgets for the reporting period as well as (3) actual inflows, outflows, and balances, stated on the government's budgetary basis.

Although the principle requires the presentation of certain budgetary comparison information as RSI, footnote 53 of GASB Statement No. 34, paragraph 130, permits governments to elect to report that information in a budgetary comparison statement as part of the basic financial statements.

Budgetary Processes

Types of Budgets

11.04 As indicated above, generally accepted accounting principles (GAAP) require the presentation of information about a government's legally adopted annual budgets for certain funds. Those presentations involve *appropriated budgets*—the expenditure authority created by the appropriation bills or ordinances that are signed into law and the related estimated revenues. An appropriated budget differs from a nonappropriated budget, which is “a financial plan for an organization, program, activity, or function approved in a manner authorized by constitution, charter, statute, or ordinance but not subject to appropriation and therefore outside the boundaries of the definition of ‘appropriated budget’” (NCGA Interpretation 10, paragraph 11, as amended).²

11.05 Governments may establish two types of budgets—monetary and performance. Monetary and performance budgets are not mutually exclusive. When one thinks of the term *budget*, one usually envisions a document and process that control governmental fund revenues and expenditures for a one-year period (or two separate annual periods, for those governments that budget on a biennial basis). That is a monetary budget. Many governments update their fixed, annual, monetary budgets periodically during the year as revenue estimates and expenditure needs change. The use of budgetary resources may be controlled at the program, department, fund, character, or object level, as discussed later in this chapter. Governments may develop monetary budgets for other purposes and periods, as follows:

- **Capital budgets.** These budgets usually present estimates of expenditures for capital outlays and the proposed means of financing them for a period of several years. Capital budgets typically emphasize major capital outlay plans and usually are updated periodically as priorities change or unanticipated projects arise. Capital budgets help governments anticipate future changes in allowable debt levels and annual debt service requirements. Even if a government legally adopts a capital budget, GASB standards do not require the government to report budgetary comparison information about that budget because it is not an annual budget. However, the government may present budgetary comparison information for that budget as supplementary information other than RSI, known as SI.

¹ The GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A), item 250, clarifies that governments that budget on a biennial basis are not exempt from the requirement for budgetary comparison reporting.

² Although this chapter discusses various types of budgets, the GASB requirements for presenting budgetary comparison information applies only to certain legally adopted budgets.

- *Proprietary fund flexible budgets.* The nature of most operations financed and accounted for through proprietary funds is such that the demand for the goods and services largely determines the appropriate level of revenues and expenses. Increased demand for the goods or services causes a higher level of expense to be incurred, but also results in a higher level of revenues. Thus, flexible budgets—prepared for several levels of possible activity—typically are used to plan, control, and evaluate proprietary fund spending. When formally adopted, the expense estimates of flexible budgets typically are not viewed as appropriations but as approved plans. A government evaluates and controls a flexible budget by comparing actual interim or annual revenues and expenses with planned revenues and expenses at the actual level of activity for the period. In some instances, however, legal provisions may require a fixed or flexible budget to be legally adopted for proprietary funds. Even if a government legally adopts a budget for proprietary funds, GASB standards do not require the government to report budgetary comparison information about that budget because presentation is only required for the general and major special revenue funds. However, the government may present budgetary comparison information for that budget as SI.

11.06 Governments also may develop performance budgets in addition to or as part of monetary budgets. Performance budgets emphasize outputs, units of work performed, or services rendered within each budgeted program, such as tons of waste collected in the rubbish disposal program, rather than simply providing for the amounts to be spent. Performance budgets relate the input of resources to the output of services. Usually, performance budgets do not constitute legally adopted budgets.

Legal Level of Budgetary Control

11.07 Because of financial reporting and auditing considerations discussed later in this chapter, the auditor needs to understand the legal level at which budgetary control is exercised. The legal level of budgetary control is the level of detail at which the government's governing body appropriates resources. Below the legal level of budgetary control, the government's management can reassign resources without governing board approval. Common legal levels of budgetary control are as follows:

- *Program level.* A program-level budget allocates resources for particular activities or operations, regardless of the funds from which the resources are provided, the departments that spend the resources, or the types of items for which the resources are spent. For example, the governing board may establish a public safety program budget and control the use of resources at that level, even though several funds provide the resources and three departments—police, fire, and emergency medical services—charge various types of items to that program.
- *Department level.* A department-level budget allocates resources to a particular department or other organizational unit, regardless of the funds from which the resources are provided, the programs that department conducts, or the types of items for which the resources are spent. For example, a government may establish a budget for the public works department and control the use of resources at that level, even though that department spends resources from several funds for various types of items and conducts both road maintenance and garbage collection programs.

- *Fund level.* A fund-level budget allocates resources from an individual fund, regardless of the departments that spend the resources, the programs those departments conduct, or the types of items for which the resources are spent. For example, a government may establish a budget for its highway special revenue fund and control the use of resources at that level, even though that fund finances various types of items for both the highway and police departments and those departments' highway construction, maintenance, and safety programs.
- *Character level.* In addition to program-, department-, or fund-level budgets, the legal level of control may be further set by character, that is, on the basis of the fiscal period the use of resources are presumed to benefit. The major character classifications are *current*, which benefits the current fiscal period; *capital outlays*, which is presumed to benefit both the present and future fiscal periods; and *debt service*, which is presumed to benefit prior fiscal periods as well as current and future periods. *Intergovernmental*, a fourth character classification, is used when one government transfers resources to another, such as when states transfer shared revenues to local governments or act as intermediaries in federally financed programs.
- *Object level.* Beyond character level, the legal level of control may be further set by object classes, that is, according to the types of items purchased or services obtained. Examples of current operating objects are personal services, supplies, and utilities. Capital outlays, debt service, and intergovernmental also are major object classifications.

11.08 In many governments, compliance with the legally adopted budget usually is required at the program, department, or fund level (or a combination of those levels), although some governments may use lower levels. Governments that establish the legal level of budgetary control at the program, department, or fund level also may monitor the use of budgetary resources at the character or object level, but this would be done to manage the use of budgetary resources rather than as a legal requirement. For example, a government may set the legal level of control at the departmental level but track each department's costs by object to provide useful information about how a given department spends its resources compared to the purposes for which it requested funding. However, as long as that department's total use of resources are less than the total budgeted level, noncompliance with budgetary requirements relating to the legal level of control would not exist. On the other hand, if the government is legally required to budget the use of resources at the object level, the fact that a given department's salaries exceed the amount budgeted for that object represents noncompliance with budgetary requirements relating to the legal level of control even though the department's total spending is less than the total amount budgeted.

Encumbrances

11.09 A component of budgetary control in governments is encumbrances, especially in general, special revenue, and capital projects funds. Encumbrances represent formal commitments (usually contracts or purchase orders) to acquire goods or services not yet received.³ Encumbrances may be recorded

³ Some governments also record preencumbrances when they intend to enter into contracts or issue purchase orders. Preencumbrances are control mechanisms and do not represent formal commitments.

in governmental fund accounts to ensure that expenditures do not exceed appropriations. Encumbrances outstanding at year-end do not represent GAAP expenditures. However, they may represent a portion of the fund balance that should be reserved for commitments outstanding as of year-end as discussed in Chapter 10, “Equity and Financial Statement Reconciliations.”

11.10 Some legal requirements may require encumbrances outstanding as of year-end to be considered expenditures and charged against current-year appropriations. In those cases, encumbrances will be included with the expenditures reported in the budgetary comparison schedule or statement. In that situation, the difference between outstanding encumbrances as of the beginning and end of the year should be a reconciling item between expenditures reported in the statement of revenues, expenditures, and changes in fund balances and those reported in the budgetary comparison schedule or statement, as discussed in paragraph 11.14. On the other hand, a legal requirement or formally adopted policy may require appropriations to automatically roll forward to cover prior-year outstanding encumbrances. In that case, the subsequent year’s original budget presentation should include those appropriation amounts carried forward.

Budgetary Basis

11.11 NCGA Interpretation 10, paragraph 6, states that the scope and method of budgetary practices are outside the scope of financial reporting standards. Ideally, a monetary budget is prepared and executed using the same basis of accounting that is used in GAAP reporting for the same operations. However, in some cases, legal provisions will mandate a different budgetary basis. In those situations, NCGA Statement 1, paragraph 88, observes that governments typically (a) maintain the accounts and prepare budgetary reports on the legally prescribed budgetary basis to determine and to demonstrate legal compliance and (b) maintain sufficient supplemental records to permit presentation of financial statements in conformity with GAAP.

Financial Reporting Considerations

Budgetary Comparison Schedules or Statements

11.12 As mentioned in the introduction to this chapter, GASB Statement No. 34 requires a budgetary comparison schedule to be presented as RSI for the general fund and for each major special revenue fund that has a legally adopted annual budget.⁴ Those schedules should present both the original and final appropriated budgets⁵ for the reporting period as well as actual budgetary inflows, outflows, and balances stated on the government’s budgetary basis. NCGA Interpretation 10, paragraph 14, requires budgetary comparisons to be presented at the legal level of budgetary control. GASB Statement No. 34 encourages governments to present a separate column in the schedules to report the variance between the final budget and the actual amounts. GASB Statement No. 34 also permits governments to present a separate column to report the variance between the original and final budget amounts. Governments may present the budgetary comparison schedules using the same format, terminology, and classifications as they use in their budget documents, or

⁴ See footnote 1.

⁵ GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, paragraph 130, defines in detail the original and final appropriated budgets. Additional guidance is provided in the GASB 34 Q&A.

using the format, terminology, and classifications consistent with the statement of revenues, expenditures, and changes in fund balances. Budgetary comparison information for other funds, such as for nonmajor special revenue funds or for capital projects or debt service funds, may be presented as SI, but not as RSI.

11.13 GASB Statement No. 34, footnote 53, allows governments to elect to report the required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as RSI.⁶ If presented as a part of the basic financial statements, the required budgetary comparison information is subject to the same minimum information requirements and allowable formats as discussed in paragraph 11.12. Governments should not present budgetary comparison information in the basic financial statements for funds other than those for which GASB Statement No. 34 requires budgetary comparison information to be presented as RSI. Footnote 53 of GASB Statement No. 34 only permits governments to move required budgetary comparison information from RSI to the basic financial statements; it does not permit governments to present additional budgetary comparison information in the basic financial statements. Budgetary comparison information for other funds, for example, for nonmajor special revenue funds or for capital projects or debt service funds, may be presented as SI.

Disclosures

11.14 Notes to RSI should disclose excesses of expenditures over appropriations in individual funds presented in the budgetary comparison schedules. As with the schedules, this disclosure is based on the legal level at which budgetary control is exercised. Further, the budgetary comparison schedules should be accompanied by information (either in a separate schedule or in notes to RSI) that reconciles budgetary information to GAAP information. If the required budgetary comparison information is instead included in the basic financial statements, those disclosures should be included in the notes to the financial statements.

11.15 Regardless of whether the required budgetary comparison information is presented as RSI or as part of the basic financial statements, if the excess of expenditures over appropriations in any fund (including those funds that are not required to be presented in the budgetary comparison information) or any other noncompliance with budgetary legal provisions is considered a material violation of finance-related legal provisions, that violation should be disclosed in the notes to the financial statements as required by NCGA Statement 1, paragraph 11. In addition, the government should disclose actions taken to address such violations, as required by GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 9.

11.16 In certain circumstances, a budget is not adopted for the general or a major special revenue fund because it is not legally required and, therefore, presentation of budgetary comparison information is not required. That situation should be disclosed in the notes to RSI to explain why what might appear to be required information is not part of the presentation. If the government chooses to present its required budgetary comparison information in the basic financial statements, that disclosure should be made in the notes to the financial statements.

⁶ The structure of the presentation requirements in GASB Statement No. 34 is such that it encourages presentation of the budgetary comparison information as required supplementary information (RSI).

Auditing Considerations

11.17 The extent of the auditor's responsibility over required budgetary comparison information depends in part on whether that information is presented as RSI or as part of the basic financial statements, as discussed in paragraphs 11.19 through 11.23. Regardless of the method of presentation and the related audit responsibility, however, the auditor may perform audit procedures relating to a government's development and control of its budget to assist in the audit of certain financial statement accounts. (See paragraphs 11.24 through 11.26.) Such audit procedures also may satisfy the auditor's responsibility for material misstatements arising from illegal acts. (See paragraphs 11.27 and 11.28.)

Internal Control Considerations

11.18 A legally adopted budget—which may take many forms, ranging from a single document that identifies all revenue sources and expenses or expenditures to numerous revenue and appropriation bills or ordinances—usually is the legal authority for the levy of taxes and the spending of moneys. Because of the legal importance of budgetary compliance and the consequences of budgetary noncompliance as described in paragraphs 11.01 and 11.02, governments frequently have extensive internal control over their budgets. A government's internal control features relating to its budget may include the following:

- Segregation of duties between budget preparation, adoption, execution, and reporting
- The adoption and communication of procedures to establish authority and responsibility for budget development, approval, and amendments
- Integration of the budgeting system with the planning process and compatibility between the type of budgeting performed and the accounting system
- Preparation of the budget in sufficient detail to provide a meaningful tool with which to monitor subsequent performance
- A process to ensure that the original budget and any subsequent budgetary amendments receive governing body approval and are subjected to public notification and hearings, as required
- Formal integration of the budget into the accounting system
- Periodic (monthly) comparison of actual revenues and expenditures to the budget, with explanation of and follow-up on significant variances
- Other processes and procedures to ensure adherence to relevant compliance requirements

Presentation of Budgetary Comparison Information

11.19 If the government presents required budgetary comparison information as RSI, the auditor has limited responsibilities for those presentations as discussed in SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558) and Chapter 4, "Planning the Audit." Those responsibilities include applying only certain limited procedures to the information, consisting principally of inquiries of management regarding the methods of measurement and presentation of the information. The auditor likely would perform those limited procedures while performing audit

procedures because of his or her other auditing considerations as discussed in paragraphs 11.24 through 11.28. That is, those audit procedures may likely encompass the limited procedures required for RSI.

11.20 When required budgetary comparison information is presented as RSI, the auditor's reporting depends on whether the document containing the RSI is in a document that is considered auditor-submitted or client-prepared. Auditors should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551) and SAS No. 52, as discussed in Chapter 14, "Audit Reporting."

11.21 If required budgetary comparison information is presented as a basic financial statement, the auditor has additional responsibilities as compared to when that information is presented as RSI. Such responsibilities include audit procedures over the budgetary information considered sufficient to render opinions on the basic financial statements.⁷ Additional audit procedures that might be performed when required budgetary comparison information is presented in the basic financial statements might include detailed testing to determine whether the budgetary comparison statement and the notes to the financial statements include the information required by GAAP for such statements and notes. (This additional procedure is in contrast with asking management whether the information is measured and presented within prescribed guidelines—one of the limited procedures for information presented as RSI.). The auditor might otherwise perform this type of audit procedure because of his or her other auditing considerations as discussed in paragraphs 11.24 through 11.28. Chapter 14 discusses auditor reporting on budgetary information presented as a basic financial statement.

11.22 Because some governments want the auditor's opinion to cover their budgetary comparison information, they want to present budgetary comparison information as a basic financial statement. As discussed in paragraph 11.13, a government may elect to present budgetary comparison information in the basic financial statements (thus subjecting it to audit coverage) for those funds for which the information is required to be presented as RSI—the general fund and each major special revenue fund that has a legally adopted annual budget. (Alternatively, the government may present the information as RSI and engage the auditor to render an opinion that the RSI is fairly presented, in all material respects, in conformity with GAAP.) For other funds, the government could present the budgetary comparison information as SI and engage the auditor to render an opinion on that SI. (The auditor's responsibility for and reporting on SI are discussed in Chapters 4 and 14.)

11.23 Chapter 14 discusses additional matters relating to budgetary comparison information that affect the auditor's report.

Audit Support for Financial Statement Assertions

11.24 An auditor may wish to perform audit procedures relating to an entity's budget to provide audit support for financial position and activity statement assertions. An auditor could consider, for example, controls to ensure that expenses/expenditures have been properly approved, monitored, and classified within the accounts to assist in the audit of those accounts. If the

⁷ The required budgetary comparison information presented as part of the basic financial statements constitutes a third financial statement relating to each of the major fund opinion units for which they are presented. See the discussion of opinion units in Chapter 4, "Planning the Audit."

auditor determines that those budgetary controls are in place and functioning properly, the auditor may be able to assess control risk for expenses/expenditures at less than the maximum and use those controls as a basis for reducing the nature, timing, and extent of substantive tests that otherwise may be necessary. If the required budgetary comparison information is presented as basic financial statements, the auditor should perform audit procedures relating to budgetary comparison statement assertions as discussed in paragraph 11.21. In those situations, the auditor's knowledge of the budgetary process and related controls should be sufficient for him or her to understand how:

- The budget is developed and adopted.
- The budget is amended.
- The original budget and amendments are incorporated into the accounting system and the budgetary comparison statements.
- Budgetary compliance is monitored and enforced.

11.25 Under SAS No. 56, *Analytical Procedures*, as amended by SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), the auditor should perform analytical procedures in both the planning and overall review phases of all audit engagements.⁸ Analytical procedures that compare actual results to either the original or the amended budget, or both, may be useful during the planning phase of the audit.

11.26 In performing audit procedures relating to an entity's budget, the auditor should consider whether the government uses its budget to control spending or, instead, uses its spending to establish the budget. Some governments adopt a preliminary budget and amend it frequently, essentially allowing the budget to follow the results of operations. In that situation, audit procedures relating to the budget may not be very useful audit support for financial position and activity statement assertions.

Budgetary Compliance Considerations

11.27 As discussed in Chapter 4, generally accepted auditing standards (GAAS) require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements arising from illegal acts that have a direct and material effect on the determination of financial statement amounts. Further, although an auditor is not required to plan and perform the audit to detect misstatements arising from illegal acts that have a material indirect effect on the financial statements, procedures applied for the purpose of forming an opinion on the financial statements may bring such possible illegal acts to the auditor's attention. Those responsibilities apply to material misstatements that arise from budgetary noncompliance, regardless of whether the budgetary information is presented as part of the basic financial statements or as RSI, or is not required by GASB standards to be reported.

- Budgetary noncompliance could have a direct and material effect on the determination of financial statement amounts if budgetary comparison information is presented as part of the basic financial statements. For example, if the government's management amended the

⁸ SAS No. 96, *Audit Documentation*, amends SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), for periods beginning on or after May 15, 2002 (with earlier application permitted), by requiring certain documentation when an analytical procedure is used as the principal substantive test of a significant financial statement assertion.

general fund budget without obtaining required governing board approval, the budgetary comparison statement's presentation of amended budget amounts would be misstated. The auditor should evaluate the effect of the noncompliance on the opinion on the general fund opinion unit. (See the discussions of opinion units in Chapter 4.)

- Budgetary noncompliance could have a direct and material effect on the determination of financial statement amounts even if budgetary comparison information is not presented as part of the basic financial statements or is not required by GASB standards to be reported. For example, consider an entity's budget law that requires that it transfer any balance in excess of legally required reserves from a debt service fund to the general fund. If that transfer is not made, the auditor should evaluate the effect of the omitted transfer on opinions on the affected opinion units. Further, the auditor may detect budgetary noncompliance that has a material indirect effect on the entity's financial statements. For example, if through inquiry and management representations, the auditor becomes aware that an entity does not adopt a legally required budget for a nonmajor special revenue fund and does not disclose the noncompliance in the notes to the financial statements, the auditor should evaluate the effect of the omitted disclosure on the opinion on the aggregate remaining fund information opinion unit.

11.28 The auditor should consider performing procedures to obtain an understanding of the laws governing the budgetary process and to determine whether budgets have been prepared and adopted in compliance with those requirements. Those audit procedures may include:

- Discussing with management or legal counsel the applicable legal provisions governing the budget and the budget's applicability to the various funds of the government
- Determining whether the budgetary process was performed in accordance with legal provisions, including those that require public notifications and hearings
- Reviewing the original budget and budgetary amendments for proper approvals
- Determining the level of budgetary control—that is, program, department, fund, character, or object, and the adequacy of the accounting system to operate at that level of control
- Determining the basis of accounting on which the budget is prepared
- Evaluating whether expenditures in excess of appropriations in individual funds (a) constitute a material violation of legal provisions and (b) are appropriately disclosed

Chapter 12

Special Purpose and State Governments

Introduction

12.01 This chapter builds on the other accounting, financial reporting, and auditing guidance elsewhere in this Guide by providing specific guidance relating to certain types of governments, primarily special-purpose and state governments. All Governmental Accounting Standards Board (GASB) pronouncements are potentially applicable to the financial statements of all governmental entities, including special-purpose governments, recognized Indian tribes that apply governmental accounting and financial reporting guidance, and states. Auditors should consider the “scope and applicability” section of each GASB pronouncement for specific applicability as well as the accounting, financial reporting, and auditing guidance in the other chapters of this Guide.

12.02 *Special-purpose governments* are legally separate entities that perform only one activity or only a few activities, such as cemetery districts, school districts, colleges and universities, utilities, hospitals and other health care organizations, and public employee retirement systems (PERS). Special-purpose governments are legally separate entities and may be primary governments, stand-alone governments,¹ or component units as defined in GASB Statement No. 14, *The Financial Reporting Entity*, and discussed in Chapter 3, “The Financial Reporting Entity.”

12.03 Auditors of special-purpose governments should consider consulting other AICPA Audit and Accounting Guides for accounting and auditing guidance as discussed in Chapter 1, “Overview and Introduction.”² They also should consider consulting the annual Audit Risk Alerts issued as complements to those Guides. This chapter discusses how certain sources of accounting guidance fit into the hierarchy of generally accepted accounting principles (GAAP) for governmental entities. Chapter 1 discusses the GAAP hierarchy for governments.

Financial Reporting Requirements for Special Purpose Governments

12.04 All legally separate special-purpose governments, whether primary governments, stand-alone governments, or component units of a primary

¹ Stand-alone governments, which include joint ventures, jointly governed organizations, and pools, often are special-purpose governments. Examples of entities that may be joint ventures and jointly governed organizations are regional transportation authorities, water treatment plants, solid waste facilities, tax bureaus, airports, and libraries. Examples of pools are public entity risk pools and governmental external investment pools.

² The accounting and financial reporting guidance in the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* does not constitute category (b) accounting and financial reporting guidance for governmental entities because the AICPA did not make that Guide applicable to those entities and the GASB did not clear it. (See the further discussion in footnote 23.) However, even though that Guide is not applicable to governmental entities, auditors should consider referring to it for specific auditing considerations because many similar activities are conducted by governmental entities and not-for-profit organizations. The relevance to governmental audits of the other AICPA Audit and Accounting Guides referred to in Chapter 1, “Overview and Introduction,” is discussed elsewhere in this chapter.

government, should prepare basic financial statements, including the notes thereto, accompanied by all appropriate required supplementary information (RSI), including a management's discussion and analysis (MD&A). (See National Council on Governmental Accounting [NCGA] Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraphs 135 and 136, as amended, for the requirements relating to a government's issuance of annual financial reports.) GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraphs 134 through 141, provides standards for the basic financial statements of special-purpose governments (as discussed below) that are designed to be appropriate to the nature and mix of the activities they perform.³ Additional details about the basic financial statements for special-purpose governments are in the GASB staff documents *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A) and *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A). In performing an audit of a special-purpose government, an auditor should evaluate whether the entity has presented the appropriate basic financial statements and RSI. (Chapters 4, "Planning the Audit," and 14, "Audit Reporting," discuss the limited procedures and auditor's reporting for RSI.)

12.05 Special-purpose governments that have only governmental activities (such as some library districts) or a combination of governmental and business-type activities⁴ (such as some school districts) should present the same basic financial statements as would a general-purpose government. That is, they should present both government-wide financial statements and fund financial statements.

12.06 Special-purpose governments engaged in a single governmental program (such as some cemetery and fire districts) may present their government-wide and fund financial statements in one of the two ways described below. A government is not considered to be engaged in a single governmental program if it budgets, manages, or accounts for its activities as multiple programs. For example, a school district with regular instruction, special instruction, vocational education, and adult education programs is not engaged in a single governmental program.

- First, the government-wide and fund financial statements could be combined with a reconciliation of the individual line items in a separate column on the financial statements. (See illustrative financial statements A-4 and B-6 in the nonauthoritative Appendix C of GASB Statement No. 34.)
- Second, the government-wide and fund financial statements could be presented separately, but the government-wide statements of activities could be presented using a different format. For example, that statement could be presented in a single column that reports expenses first, followed by revenues (by major sources). The difference between those amounts is net revenue (expense) and should be followed by contributions to permanent and term endowments, special and

³ See Chapter 2, "Financial Reporting," for the basic financial statements required for a general-purpose government. That chapter also provides an overview of required supplementary information (RSI). Various chapters of this Guide discuss note disclosure requirements.

⁴ The GASB's definitions of *governmental activities* and *business-type activities* are discussed in Chapter 2.

extraordinary items, transfers, and beginning and ending net assets. (See illustrative financial statement B-5 in the nonauthoritative Appendix C of GASB Statement No. 34.)

12.07 Special-purpose governments engaged only in business-type activities should present the financial statements required for enterprise funds—a statement of net assets or balance sheet; a statement of revenues, expenses, and changes in fund net assets or fund equity; and a statement of cash flows.⁵ (The financial statements of special-purpose governments engaged only in business-type activities should measure, recognize, and report transactions and balances using proprietary fund accounting and financial reporting standards as provided in GASB pronouncements and this Guide.) This requirement could affect special-purpose governments that reported as of June 30, 1999, using AICPA not-for-profit model, as defined in GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*. GASB Statement No. 34 permits those entities to use enterprise fund accounting and financial reporting, even if they do not meet the Statement's criteria for reporting as an enterprise fund. GASB Statement No. 34, paragraph 123, encourages special-purpose governments engaged only in business-type activities to present a statement of activities as supplementary information other than RSI, known as SI. (Chapters 4 and 14 discuss audit procedures and auditor's reporting for SI.)

12.08 Special-purpose governments engaged only in fiduciary activities should present the financial statements required for fiduciary funds—a statement of fiduciary net assets and a statement of changes in fiduciary net assets. The financial statements of special-purpose governments engaged only in fiduciary activities should measure, recognize, and report transactions and balances using fiduciary fund accounting and financial reporting standards as provided in GASB pronouncements and this Guide.

12.09 Chapters 4, 13, “Concluding the Audit,” and 14 discuss the nature and effect of opinion units in planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements. In an audit of a special-purpose government that has only governmental activities or a combination of governmental and business-type activities, the opinion units normally are the governmental activities, the business-type activities, each major governmental and enterprise fund, and the aggregate remaining fund information (consisting of the nonmajor governmental and enterprise funds, the internal service funds, and the fiduciary funds), as applicable. (As discussed in Chapter 4, in certain circumstances, auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit referred to as the *aggregate discretely presented component unit and remaining fund information opinion unit*.) In audits of special-purpose governments engaged only in business-type activities and that present more than one enterprise fund (such as a utility district that provides water,

⁵ Some special-purpose governments engaged only in business-type activities may report fiduciary activities in fiduciary funds. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, does not require those governments to present a government-wide financial statement because the activity reported in fiduciary funds is not part of government-wide financial statements. Item 260 of the GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A) indicates that a special-purpose government engaged only in business-type activities that has discretely presented component units that are engaged in governmental activities should present government-wide statements.

sewer, electrical, and trash services), the opinion units are each major enterprise fund and the aggregate nonmajor enterprise funds, if any, which represents “remaining fund information.”⁶ In audits of special-purpose governments engaged only in fiduciary activities and that present more than one fiduciary fund or fund type (such as a PERS with more than one defined benefit pension plan), the aggregate fiduciary funds are a single opinion unit that represents, in effect, “remaining fund information.” In addition, a government’s aggregate discretely presented component units should be a separate opinion unit. For all opinion units, including the aggregate opinion units, the auditor should consider quantitative and qualitative factors in determining the nature, timing, and extent of procedures on the various accounts within the unit, as discussed in Chapter 4. Chapter 4 also discusses how the terms of the engagement may require the auditor to set the scope of the audit and assesses materiality at a more-detailed level than by the opinion units required for the basic financial statements.

Compliance Requirements

12.10 Governments are subject to various legal and contractual provisions (compliance requirements) arising from, for example, federal, state, and local laws; grants, contributions, and appropriations from other governments; and debt covenants. The auditor should consider whether it is necessary to evaluate the entity’s compliance with those requirements as part of the financial statement audit. Chapter 4 discusses the auditor’s responsibility for material financial statement misstatements arising from illegal acts, both those that have a direct and material effect on the determination of financial statement amounts and those that have a material indirect effect on the financial statements.

Specific Guidance for Special-Purpose Governments⁷

Hospitals and Other Health Care Providers⁸

12.11 There are various differences between the accounting and financial reporting standards for hospitals and other health care providers that are governments and those that are not-for-profit organizations. The listing at paragraph 12.64 highlights many of those differences. Auditors should become familiar with governmental standards for hospitals and other health care providers as discussed in this section and elsewhere in this Guide.

12.12 Generally, governmental hospitals and other health care providers use enterprise fund accounting and financial reporting. If a hospital or other health care provider does not meet the criteria in GASB Statement No. 34, paragraph 67, requiring the use of enterprise funds (as discussed in Chapter 2, “Financial Reporting”), it may use either governmental fund or enterprise

⁶ If a special-purpose governments engaged only in business-type activities reports fiduciary activities in fiduciary funds, the fiduciary funds are part of the remaining fund information opinion unit.

⁷ Although this section is written in terms of special-purpose governments, the accounting, financial reporting, and auditing considerations are usually equally applicable when the activity is conducted as a function or program of a general-purpose government.

⁸ See also the discussion of Medicaid in the section of this chapter entitled “Specific Guidance for State Governments.”

fund accounting and financial reporting. Often, governments do not use enterprise funds to report activities relating to the long-term institutional care (which includes health care) of the elderly, children, and the mentally impaired because they do not meet the criteria requiring the use of enterprise funds and because user fees are not a principal revenue source for the activity. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of governmental hospitals and other health care providers, as discussed in paragraph 12.09. Governmental hospitals and other health care providers are subject to various legal and contractual provisions that may affect their financial statements. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit.

12.13 As discussed in Chapter 1, the AICPA Audit and Accounting Guide *Health Care Organizations* includes in its scope governmental health care organizations when they issue separate financial statements using enterprise fund accounting and reporting. Thus, the auditor should consult that Guide for auditing considerations unique to those health care organizations.⁹ Further, *Health Care Organizations* was cleared by the GASB before it was issued. Therefore, the Guide constitutes category (b) accounting and financial reporting guidance for those governmental health care organizations.¹⁰ In practice, auditors of governmental health care organizations that issue separate financial statements using enterprise fund accounting and reporting may use *Health Care Organizations* as the primary source of guidance because that Guide addresses transactions that are unique to or prevalent in the health care industry. This Guide, however, contains information about governmental accounting and financial reporting standards and other matters that are unique to or prevalent in government and not included in *Health Care Organizations*. Those matters are discussed throughout this Guide, but the most potentially relevant matters for the financial statements of legally separate governmental hospitals and other health care providers are in the section of this chapter entitled "Financial Reporting Requirements for Special-purpose Governments," the "Auditing Considerations" sections of other chapters, Chapters 4, 13, 14, and 16, "Auditor Association with Municipal Securities Filings," and Appendix B, "Category B Guidance." Also particularly applicable may be the discussions in Chapter 8, "Expenses/Expenditures and Liabilities," on unrelated business income taxes and fund-raising costs.

School Districts

12.14 School districts provide elementary and secondary education programs. Depending on state laws, school districts generally operate as (a) part

⁹ Even though the AICPA Audit and Accounting Guide *Health Care Organizations* only applies to governmental health care organizations when they issue separate financial statements using enterprise fund accounting and reporting, auditors should consider referring to that Guide in other financial reporting situations for specific auditing considerations relating to governmental health care organizations (such as, for example, audit procedures relating to amounts due from discharged patients and third-party payors).

¹⁰ **Transition note:** A previous version of that AICPA Audit and Accounting Guide (entitled *Hospital Audit Guide*) had been category (a) guidance for governmental entities because its use had been required by NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, footnote 4. However, the current (1996) Guide, which superseded the previous Guide, became category (b) guidance when it was cleared by the GASB. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, supersedes NCGA Statement 1, footnote 4.

of the legal entity of the sponsoring government,¹¹ (b) primary governments, (c) stand-alone governments, or (d) legally separate entities that are component units of another government. As discussed in paragraphs 12.05 and 12.06, legally separate school districts usually present both government-wide and fund financial statements. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of school districts, as discussed in paragraph 12.09.

Compliance Requirements

12.15 School districts are subject to various legal and contractual provisions, including state-established accounting and reporting requirements, that may affect their financial statements. For example, many states require their school districts to use standardized charts of accounts for their basic financial statements and for special-form annual reports. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the district's compliance with those requirements as part of the financial statement audit.

Attendance Reporting

12.16 Most school districts receive financial assistance from state governments based on some measure of student attendance. Attendance data also may affect the amount of certain types of federal awards. Attendance data typically are determined at individual schools and reported on a district-wide basis. Some states may require auditors to audit or otherwise perform procedures on attendance data. Those engagements should be performed under the provisions of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, Chapter 6, "Compliance Attestation" (AICPA, *Professional Standards*, vol. 1, AT sec. 601). Further, the auditor should consider evaluating a district's attendance reporting as part of the audit of the district's financial statements if incorrect data could have a direct and material effect on the determination of financial statement amounts. (In some cases, a school district's attendance reporting does not have a direct and material effect on the determination of the current year's financial statement amounts but, rather, affects the calculation of state and federal subsidies in a future period.)

Summer Payroll

12.17 Some school districts pay teachers on a twelve-month basis for services during the nine-month academic year. Because payroll costs are exchange transactions that should be recognized when the employees provide the services, school districts should accrue expenses/expenditures and liabilities at year-end for summer salaries earned but not yet paid. Some school districts with June 30 fiscal year-ends facilitate that expense/expenditure accrual by writing the checks for summer payroll as of year-end and holding them for later distribution. In those situations, the auditor should consider evaluating the internal control over the safeguarding and subsequent distribution of those checks, as well as consider determining that the amounts to be paid during the summer months are reflected in the accounts as a liability and not a reduction of cash.

¹¹ School districts that are part of the legal entity of a sponsoring government sometimes issue separate individual fund or departmental financial statements, as discussed in Chapter 14, "Audit Reporting."

Student Activity Funds

12.18 Most school districts have petty cash funds or bank accounts for student-generated moneys. In some cases, those amounts may be under the control of individual school principals and not subject to the district's budgetary or centralized accounting and purchasing controls. States have different legal provisions for how the amounts in student activity funds may or should be used. Student activity funds should be reported in a district's financial statements as, for example, special revenue or agency funds, depending on the nature of the requirements concerning the use of the funds. A district's student activity funds may be of concern to an auditor despite the small amounts involved because many receipts are in the form of cash, the receipts may be handled by several persons after the district becomes accountable for the amounts but before they are deposited, and adverse publicity can result from a loss or misuse of the funds. Therefore, the auditor should consider evaluating the internal control over and the use of the funds. However, the auditor should keep in mind that a district's accountability for student activity moneys may differ depending on state law and the nature of the fund-raising activity. For example, a school district may be accountable for gate receipts for functions held on its campus, but not accountable for receipts from an off-campus fund-raising activity until a district employee or official takes custody of the moneys.

Child Nutrition Programs

12.19 Most school districts participate in U.S. Department of Agriculture (USDA) programs that provide cash and commodities to provide nutritious meals to students. The auditor should consider whether it is necessary to evaluate a districts' compliance with the USDA's regulations for those programs as part of the financial statement audit. Revenue for the cash portion of those programs should be recognized using the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as described in Chapter 6, "Revenues and Receivables." The 2nd GASB 34 Q&A, item 152, states that food commodities are within the scope of GASB Statement No. 33 and should be recognized as revenue in the period when all eligibility requirements are met (typically, when the commodities are received). Governmental fund balances resulting from that recognition may be reported as reserved. Further, some states have established specific accounting and financial reporting requirements for child nutrition programs.

Charter Schools

12.20 Many states have laws permitting the creation of charter schools, which are publicly funded, nonsectarian schools that operate free of many of the regulations, restrictions, and mandates of traditional public schools. State laws define the organizations that grant the charters (usually local school districts or the state department of education) as well as eligible applicants (usually governmental entities or one or more persons or organizations). Charter schools are established under law and contract as separate legal entities and are accountable for their results at the end of the contract period, which is usually three to five years in length. Per-student state and local funds generally follow students to a charter school. Depending on legal and contractual provisions, a charter school may be a governmental or nongovernmental entity, and may be a component unit of a governmental entity. (See the definition of governmental entities in Chapter 1.) Standardized accounting and financial reporting requirements that states have developed for public schools also may apply to charter schools.

Airports

12.21 Generally, governmental airports are reported using enterprise funds. If an airport does not meet the criteria in GASB Statement No. 34, paragraph 67, requiring the use of enterprise funds (as discussed in Chapter 2), it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of governmental airports, as discussed in paragraph 12.09. Airports are subject to various legal and contractual provisions that may affect their financial statements. For example, provisions of grants from the U.S. Federal Aviation Administration (FAA) may require that the airport's revenues and other resources be used only for on-airport purposes and not be diverted to off-airport uses. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the airport's compliance with those requirements as part of the financial statement audit.

12.22 Some airports receive revenues from passenger facility charges (PFCs), which are small-dollar passenger enplanement fees that airports charge to help pay for capital development projects. An airport is required to receive approval from the FAA to impose PFCs and to comply with the FAA's requirements for the use of PFCs. Airlines collect PFCs through the ticket sales process and remit them to the appropriate airports. Federal regulations require an audit of PFCs, and the FAA's *Passenger Facility Charge Audit Guide for Public Agencies* provides auditors with the procedures for auditing and reporting on PFCs received and expended by airports.

12.23 GASB Statement No. 34, paragraph 102, indicates that PFCs normally would not be reported as components of operating income in a proprietary fund's statement of revenues, expenses, and changes in fund net assets. Further, PFCs are identified in paragraph 102 of GASB Statement No. 34 and in the nonauthoritative Basis for Conclusions of GASB Statement No. 33 (paragraph 50) as exchange-like transactions, and, thus, revenue recognition should be based on the occurrence of the exchange (that is, the passenger enplanement). The auditor should consider evaluating whether PFCs have been properly classified and recognized in the financial statements.

Public Housing Authorities

12.24 Public housing authorities (PHAs) provide shelter to low-income persons and generally receive substantial capital and operating grants from the U.S. Department of Housing and Urban Development (HUD). PHAs provide shelter by owning and managing housing developments, generally referred to as the low-income program. They also provide shelter through section 8 programs by giving participants vouchers for rent subsidies that permit them to locate their own housing and by paying rent subsidies directly to private landlords. In addition, PHAs may finance low-interest mortgages and engage in urban renewal activities. Depending on state and local laws, PHAs, including those of recognized Indian tribes, generally operate as (a) departments of the sponsoring government, (b) stand-alone governments, or (c) legally separate entities that are component units of another government. Legally separate PHAs may be created by a single sponsoring government. Alternatively, they can be created as joint ventures of several governments or as independent regional authorities.

12.25 Generally, PHAs are reported using enterprise funds. If a PHA does not meet the criteria in GASB Statement No. 34, paragraph 67, requiring the

use of enterprise funds (as discussed in Chapter 2), it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on the audits of PHAs, as discussed in paragraph 12.09.

12.26 HUD has established *Uniform Financial Reporting Standards* (UFRS) and written guidelines that require PHAs that own HUD-assisted housing to submit financial information electronically to HUD using a template known as the Financial Data Schedule (FDS). For purposes of those submissions, HUD requires PHAs to prepare their basic financial statements in conformity with GAAP and to have those financial statements audited. HUD also requires PHAs to include the FDS as SI that accompanies their basic financial statements and for auditors to attest to whether that data is fairly presented in relation to the basic financial statements. (Chapters 4 and 14 discuss the audit procedures and auditor's reporting for SI.) HUD also requires a PHA to obtain an agreed-upon procedures engagement in which the auditor compares the authority's electronically submitted data to the hard copies of the audit report and FDS.

12.27 The auditor should be familiar with the various federal housing grant program requirements as well as other compliance requirements that affect the PHA, and consider whether it is necessary to evaluate the authority's compliance with those requirements as part of the financial statement audit. (See paragraph 12.10.) In addition, the auditor should consider confirming directly with HUD the operating subsidies, program grants, and loans and other housing development and modernization debt relating to the PHA to determine that receivable and revenue amounts are properly recognized and reported. The auditor also should consider consulting the annual Audit Risk Alert *State and Local Governmental Developments*, which often addresses regulatory developments relating to PHAs.

Financing Authorities

12.28 Many governmental entities establish financing authorities to make loans to specific types of recipients. The purpose of those loans is to lower the costs of borrowing for the recipients while advancing or achieving some public purpose. Sometimes the recipients of those loans are members of special interest groups (for example, as with an authority that provides loans to veterans, farmers, or low-income homeowners). Sometimes those recipients are other governmental entities or not-for-profit organizations (for example, a school or hospital financing authority that provides loans for new facilities). Sometimes those recipients are for-profit entities (for example, an economic or industrial development authority that provides loans for plant expansion, thereby increasing a community's employment level and tax base). Financing authorities typically issue revenue bonds to finance their activities.

12.29 Financing authorities generally meet the provisions in GASB Statement No. 34, paragraph 67, requiring reporting as an enterprise fund (as discussed in Chapter 2). If a financing authority does not meet the criteria requiring the use of enterprise funds, it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of financing authorities, as discussed in paragraph 12.09.

12.30 If an authority finances the purchase or construction of capital assets for other entities, it generally takes title to the assets and leases them to the recipients. Ownership of the assets passes to the lessees when the bonds mature and are retired. The lease or loan payments the authority receives are used to pay the revenue bond principal and interest. Authorities typically charge, to the entities benefiting from the debt issue, fees in excess of the amounts required for bond principal and interest payments to finance the authority's administrative costs. In some cases, financing authorities develop a permanent capital base that is used for making loans and, occasionally, grants to recipients. The accounting, financial reporting, and auditing considerations for capital leases when a government is the lessor are discussed in Chapter 7, "Capital Assets." See also paragraph 12.32 concerning leases between a primary government and its component units.

12.31 Many authorities that finance capital assets often do not become directly involved in either purchasing or constructing the assets or repaying the debt. A financial institution acting as trustee usually administers the debt service. In such cases, practice supports (a) reporting the debt and related capital lease receivable in the authority's financial statements or (b) disclosing the debt and related capital lease receivable in the notes to the financial statements. The authority should report in its financial statements fees and administrative expenses. See Chapter 8 for a further discussion of this type of debt—known as *conduit debt*—and the disclosures required by GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*.

12.32 Sometimes, a government may create a financing authority solely to finance its own capital assets, such as state office buildings or university dormitories. In those situations, the sponsoring government usually creates the authority to shield the borrowing from its own debt limits or other debt restrictions. The authority generally issues revenue bonds, takes title to the assets and leases them to the sponsoring government, and uses the lease payments to repay the debt principal and interest. Those authorities usually are component units of the sponsoring governments. The accounting and financial reporting for lease agreements between primary governments and their component units is specified in NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, paragraphs 22 through 26, as amended, and depends on whether the component unit is presented in the reporting entity financial statements as a blended component unit or, instead, as a discretely presented component unit.¹² (See the criteria for component units, blended component units, and discretely presented component units in Chapter 3.)

- If the component unit is blended and thus reported as part of the primary government, the criteria of Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, as amended and interpreted, do not apply to the lease agreement. Instead, the public authority's debt and assets should be reported as a form of the primary government's debt and assets. For example, the leased assets would be reported as general capital assets, and the related debt would be reported as a general long-term liability in the government-wide statement of net assets. The debt service activity of the public authority would be reported as a debt service activity of the primary government.

¹² If the public authority is not a component unit, accounting and financial reporting for lease agreements between the authority and the lessee government should be treated in the same manner as any other lease agreement of a state or local government, using the criteria of Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, as amended and interpreted.

- If the component unit is discretely presented, the lease arrangement should be treated in the same manner as any other lease agreement of a state or local government (that is, the criteria of FASB Statement No. 13, as amended and interpreted, apply). However, related capital lease receivables and payables should not be combined with other amounts due to or from component units, or with capital lease receivables and payables with organizations outside of the reporting entity. For additional guidance on accounting, financial reporting, and auditing for lease transactions, see Chapters 6, 7, and 8.

12.33 NCGA Statement 5, paragraph 26, requires that when lease arrangements exist between state and local governments and public authorities, the related-party considerations of FASB Statement No. 13, paragraph 29, should be considered to determine if there are special reporting and disclosure requirements. FASB Statement No. 13, paragraph 29, provides that in cases where it is clear that the terms of the lease transaction have been significantly affected by the fact that the lessee and lessor are related, “the classification and/or accounting shall be modified as necessary to recognize the economic substance rather than legal form.” That paragraph further provides that “the nature and extent of leasing transactions with related parties shall be disclosed.”

12.34 Finance authorities are subject to various compliance requirements. The auditor should consider whether it is necessary to evaluate an authority’s compliance with those requirements as part of the financial statement audit. (See paragraph 12.10.) Further, the accounting and financial reporting guidance in the AICPA Audit and Accounting Guide *Audits of Finance Companies* does not constitute category (b) accounting and financial reporting guidance for financing authorities because the AICPA did not make that Guide applicable to governmental entities and the GASB did not clear it. However, even though that Guide does not apply to financing authorities, auditors should consider referring to it for specific auditing considerations relating to financing authorities (such as, for example, audit procedures relating to the allowance for loan losses). Note that the AICPA anticipates publishing, in late 2002, the Audit and Accounting Guide *Financial Institutions*, which will combine and redraft chapters from the existing AICPA Guides for *Banks and Savings Institutions*, *Credit Unions*, and *Finance Companies*.

Transportation Systems

12.35 Legally separate transportation systems (which provide subway, bus, rail, or some other transportation service) may be created by a single sponsoring government, as joint ventures of several governments, or as independent regional authorities. A significant accounting, financial reporting, and auditing consideration for some transportation systems is infrastructure. See the discussion about infrastructure in Chapter 7. Some transportation systems meet the criteria in GASB Statement No. 34, paragraph 67, requiring reporting as an enterprise fund (as discussed in Chapter 2). If a transportation system does not meet those criteria, it may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of transportation systems, as discussed in paragraph 12.09.

12.36 Because of low rates or low ridership, many public transportation systems receive grants and appropriations from other governments to finance facilities, equipment, and operating expenses. Those grants and appropriations subject a system to various legal and contractual provisions that may affect

its financial statements. For example, the U.S. Department of Transportation's Federal Transit Administration issues circulars that contain grant management guidelines for its various programs. The auditor should consider whether it is necessary to evaluate the system's compliance with those requirements as part of the financial statement audit. (See paragraph 12.10.) Further, as discussed in Chapter 6, such grants and appropriations reported in enterprise funds generally should not be reported as operating revenue but, rather, as nonoperating revenue or as capital contributions, reported separately after nonoperating revenues and expenses.

Utilities

12.37 Electric, water, gas, sewer, and other utility operations often meet the criteria in GASB Statement No. 34, paragraph 67, requiring the use of enterprise funds (as discussed in Chapter 2). If those criteria are not met, the utility may use either governmental fund or enterprise fund accounting and financial reporting. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of utilities, as discussed in paragraph 12.09. Utilities are subject to various legal and contractual provisions that may affect their financial statements. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit.

12.38 A governmental utility's services often are rate regulated, with those rates established by the utility's governing body. GASB Statement No. 34 permits qualifying enterprise funds to apply the provisions of FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, as amended and interpreted,¹³ within the general rules for the use of private-sector standards by governmental entities.¹⁴ Generally, under FASB Statement No. 71, as amended and interpreted, a rate-regulated governmental entity should follow applicable GASB and FASB pronouncements for measurement and recognition unless its regulator has provided alternative measurement or recognition requirements. FASB Statement No. 71, as amended and interpreted, only applies to alternative measurement and recognition requirements; it does not provide for alternative regulatory financial statement formatting or note disclosures. Therefore, governmental utilities should apply the financial statement formatting and note disclosure requirements of GASB Statement No. 34 and other applicable GASB and FASB pronouncements for those financial statements to be in conformity with GAAP.¹⁵ In auditing a public utility, the auditor should determine whether the utility's services are rate regulated and, if so, the entity's accounting policy with regard to applying the provisions of FASB Statement No. 71, as amended and interpreted. (See the further discussion of the accounting for rate-regulated services in the section on user fees in Chapter 6.)

¹³ Other governmental services not normally considered utility services, such as municipal solid waste landfills, also may be rate-regulated and may qualify to use the provisions of FASB Statement No. 71, as amended and interpreted.

¹⁴ See the full discussion of the use of private-sector accounting and financial reporting standards by governmental entities in Chapter 2.

¹⁵ For example, an electric utility may want to present line items in its statement of net assets or balance sheet using aggregations and sequences that are inconsistent with some of the requirements of GASB Statement No. 34. To conform with generally accepted accounting principles (GAAP), the presentation in that statement should be consistent with the requirements of GASB Statement No. 34 and other applicable GASB and FASB pronouncements.

Public Employee Retirement Systems

12.39 Public employee retirement systems (PERS) are governmental entities that administer one or more pension plans;¹⁶ they also may administer other types of employee benefit plans, including postemployment healthcare plans and deferred compensation plans. The principal GASB standards for the accounting and financial reporting of PERS (including for reporting in the financial statements of a sponsoring or employer government) are GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. The GASB staff document *Guide to Implementation of GASB Statements 25, 26, and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers: Questions and Answers* provides additional guidance.

12.40 Each defined benefit pension plan and postemployment healthcare plan administered by a PERS should be reported as a separate pension (or other employee benefit) trust fund either by (a) presenting a separate column on the financial statements for each plan administered or (b) presenting combining statements for those plans as part of the basic financial statements. The financial statements for each plan should be a statement of plan net assets and a statement of changes in plan net assets, which should be prepared using the economic resources measurement focus and the accrual basis of accounting, except for certain liabilities as discussed below. Among the standards from GASB Statements No. 25 and 26 for the financial statements and related note disclosures of defined benefit pension plans and postemployment healthcare plans are the following:

- The statement of plan net assets should provide information about the fair value and composition of net assets and should not report the actuarially determined funded status of the plan. Plan receivables generally are short term and consist of contributions due as of the reporting date from employers, plan members, and other contributors, and interest and dividends on investments. Receivables should include amounts due pursuant to formal commitments as well as statutory or contractual requirements. Most plan investments should be reported at their fair value at the reporting date. (See the discussion of the accounting and financial reporting for plan investments and for reverse repurchase agreements and securities lending transactions in Chapter 5, “Cash, Investments, and Investment-Related Activity.”) Plan liabilities generally consist of benefits and refunds due to plan members and beneficiaries (which should be recognized when due and payable in accordance with the terms of the plan) and accrued investment and administrative expenses (which should be recognized on the accrual basis). Plan liabilities do not include actuarial accrued liabilities for benefits that are not due for payment at the reporting date. The difference between total plan assets and total plan liabilities at the reporting date should be captioned “net assets held in trust for pension benefits” (and referenced to the plan’s schedule of funding progress—see paragraph 12.42).

¹⁶ Pension plans may be defined contribution plans or defined benefit plans. Defined benefit pension plans may be single-employer plans, agent multiple-employer plans, or cost-sharing multiple-employer plan. Those different types of plans are discussed in Chapter 8, “Expenses/Expenditures and Liabilities.”

- The statement of changes in plan net assets should report the additions to, deductions from, and net increase (or decrease) for the year in plan net assets. Recognition of additions and deductions should be consistent with the requirements for the recognition of plan receivables and liabilities. The additions section of the statement should separately display contributions from employers, plan members, and other sources and net investment income. (See the additional discussion concerning net investment income in Chapter 5.) The deductions section of the statement should separately display (a) benefits and refunds to plan members and beneficiaries and (b) total administrative expense.
- The notes to the financial statements should include specific information in the following categories: plan description, significant accounting policies, contributions and reserves, and investment concentrations. When a plan's financial statements are presented in both an employer's report and a separate GAAP report, the employer may limit its disclosures to certain items if it discloses information about how to obtain the separate report. (See paragraph 12.43 concerning determining whether the separate report is a GAAP report.)

12.41 GASB Statement No. 34, paragraph 141, requires PERS to apply that Statement's measurement focus, basis of accounting, and display requirements to all plans other than defined benefit pension plans and postemployment healthcare plans. Combining financial statements are not required but are encouraged for those other plans.

12.42 For many defined benefit pension plans, GASB Statement No. 25 requires the presentation of a schedule of funding progress and a schedule of employer contributions as RSI immediately after the notes to the financial statements. The required schedules are (a) a schedule of funding progress that reports the actuarial value of assets, the actuarial accrued liability, and the relationship between the two over time and (b) a schedule of employer contributions that provides information about the employer's annual required contributions (ARC) and the percentage of the ARC recognized by the plan as contributed. Note disclosures related to the required schedules should be presented after the schedules and should include the actuarial methods and significant assumptions used for financial reporting. GASB Statement No. 26 does not require those RSI schedules for postemployment health care plans but, if presented as SI, requires that the schedules include all information that is required for pension plans. (Chapters 4 and 14 discuss the audit procedures and auditor's reporting for RSI and SI.)

12.43 When pension and postemployment healthcare plans are included in a primary government's financial statements, GASB Statement No. 34, paragraph 106, requires presentation of the financial statements for the individual plans in the notes to the financial statements if separate GAAP financial reports have not been issued. If separate, GAAP financial reports have been issued, the notes should include information about how to obtain those separate reports. An unqualified auditor's opinion on a plan's separate report could provide evidence that the report conforms with GAAP. If a plan's separate report is not presented in conformity with GAAP, the primary government is not allowed to limit its disclosure of plan information to a reference to the separate report.

12.44 The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of PERS, as discussed in paragraph 12.09. Further, the accounting and financial reporting

guidance in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* does not constitute category (b) accounting and financial reporting guidance for PERS because the AICPA did not make that Guide applicable to governmental entities and the GASB did not clear it. However, even though that Guide does not apply to PERS, auditors should consider referring to it for specific auditing considerations relating to PERS (such as, for example, evaluating actuarial information). Although the audit objectives for PERS are similar to those for private-sector pension plans, the auditor should be aware that the Employee Retirement Income Security Act (ERISA) does not apply to governmental entities. Instead, state and local laws and regulations that govern the operations of PERS may affect, for example, allowable investments, investment income allocation, funding requirements, participant eligibility and vesting, and payments to plan members and beneficiaries. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with legal and contractual provisions as part of the financial statement audit.

Public Entity Risk Pools

12.45 A public entity risk pool is a cooperative group of governmental entities joining together to finance an exposure, liability, or risk relating to, for example, property and liability, workers' compensation, or employee health care. A pool may be a stand-alone entity or a component unit of or a part of a governmental entity that acts as the pool's sponsor. All public entity risk pools should account for their activities in an enterprise fund regardless of whether there is a transfer or pooling of risk (and regardless of the criteria in GASB Statement No. 34, paragraph 67, concerning the conditions for using enterprise funds). The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of public entity risk pools, as discussed in paragraph 12.09. Public entity risk pools are subject to various legal and contractual provisions that may affect their financial statements. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit.

12.46 The principal GASB pronouncements relating to the accounting and financial reporting for public entity risk pools are GASB Statements No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, and No. 30, *Risk Financing Omnibus*; and GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*. The GASB staff document *Guide to Implementation of GASB Statement 10 on Accounting and Financial Reporting for Risk Financing and Related Insurance Issues: Questions and Answers* provides additional guidance.

12.47 As discussed in Chapter 1, the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* includes governmental entities (specifically public entity risk pools) in its scope, and, thus, auditors should consult that Guide for auditing considerations unique to public entity risk pools. Further, *Audits of Property and Liability Insurance Companies* was cleared by the GASB before it was issued. Therefore, the accounting and financial reporting guidance in that Guide constitutes category (b) accounting and financial reporting guidance for public entity risk pools. In practice, auditors of public entity risk pools may use *Audits of Property and Liability Insurance Companies* as the primary source of guidance for audits of those

entities because that Guide addresses transactions that are unique to or prevalent in the insurance industry. This Guide, however, contains information about governmental accounting and financial reporting standards and other matters that are unique to or prevalent in government and not included in *Audits of Property and Liability Insurance Companies*. Those matters are discussed throughout this Guide, but the most potentially relevant matters for the financial statements of legally separate public entity risk pools are in the section of this chapter entitled “Financial Reporting Requirements for Special-purpose Governments,” the “Auditing Considerations” sections of other chapters, Chapters 4, 13, 14, and 16, and Appendix B.

12.48 GASB Statement No. 10, paragraphs 18 through 50, as amended and interpreted, provide accounting and financial reporting guidance for public entity risk pools in which there is some transfer or pooling (sharing) of risk. Those standards concern the recognition of various revenues and costs (such as premium revenues, claims costs, policy or participation contract acquisition costs, and policyholder dividends), the valuation of investments (see Chapter 5), and certain specific disclosures. GASB Statement No. 10, as amended by GASB Statement No. 30, requires certain revenue and claims development information to be included as RSI immediately after the notes to financial statements in separate pool financial reports. Pools included as part of a reporting entity and that do not issue separate financial reports should present the RSI after the notes to the reporting entity’s financial statements. However, if the reporting entity issues a comprehensive annual financial report, GASB Statement No. 30, paragraph 7, permits those pools to present the RSI as statistical information. However, the placement of that information with statistical information does not change its character as RSI, or the nature of the limited procedures or the auditor’s reporting on it. (Chapters 4 and 14 discuss the limited procedures and auditor’s reporting for RSI.)

12.49 GASB Statement No. 10, paragraph 51, provides that public entity risk pools that do not transfer or pool risk among participants are acting as claims servicers and not insurers. The activity statements of these pools should report claims servicing revenue and administrative costs. Amounts collected or due from pool participants and paid to settle claims should be reported as a net asset or liability on an accrual basis.

External Investment Pools

12.50 An external investment pool is an arrangement that commingles (pools) the moneys of more than one legally separate entity and invests, on the participants’ behalf, in an investment portfolio; one or more of the participants is not part of the sponsor’s reporting entity. External investment pools sponsored by individual state or local governments or jointly by more than one government are known as *governmental external investment pools*.

12.51 The principal GASB pronouncement relating to the accounting and financial reporting for governmental external investment pools is GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. The GASB staff document *Guide to Implementation of GASB Statement 31 on Accounting and Financial Reporting for Certain Investments and for External Investment Pools: Questions and Answers* provides additional guidance.

12.52 The manner in which governmental external investment pools value their investments depends on whether the pool has a policy to and operates like a Securities and Exchange Commission (SEC)-registered money

market fund. Pools that operate similarly to those money market funds, which are termed *2a7-like pools*, are permitted to report their investments at amortized cost. Otherwise, governmental external investment pools report investments at fair value, except that short-term debt investments with remaining maturities of up to ninety days at the date of the financial statements may be reported at amortized cost, provided that the fair value of those investments is not significantly affected by the impairment of the credit standing of the issuer or by other factors. Guidance for valuing particular types of investments at fair value and for measuring investment income are in GASB Statement No. 31 and described in Chapter 5.

12.53 GASB Statement No. 31, paragraph 17, states that separate or stand-alone annual financial reports for governmental external investment pools should include a statement of net assets and a statement of changes in net assets prepared on the economic resources measurement focus and the accrual basis of accounting. All investment income, including changes in the fair value of investments, should be reported in the statement of changes in net assets. GASB Statement No. 31, paragraph 13, provides that when the change in the fair value of investments is identified separately as an element of investment income, it should be captioned “net increase (decrease) in the fair value of investments.” The stand-alone reports of governmental external investment pools may separately display realized gains and losses in their separate financial reports provided they make disclosures in the notes to the financial statements with certain prescribed language. (See GASB Statement No. 31, paragraph 15, for that language.)

12.54 GASB Statement No. 31, paragraph 17, provides certain disclosure requirements for the separate financial reports of governmental external investment pools, in addition to those required by other GASB standards as discussed in other chapters of this Guide.

12.55 GASB Statement No. 31, paragraph 18, as amended by GASB Statement No. 34, requires governments that sponsor one or more external investment pools (sponsoring governments) to report the external portion¹⁷ of each pool as a separate investment trust fund, presenting statements of fiduciary net assets and changes in fiduciary net assets for each investment trust fund and captioning the difference between the external pool assets and liabilities as net assets held in trust for pool participants. This requirement for reporting each pool as a separate fund applies to the sponsoring government’s combining and individual fund financial statements, which are not part of the government’s basic financial statements. Rather, combining and individual fund financial statements are presented as SI. (Chapters 4 and 14 discuss the audit procedures and auditor’s reporting for SI.)

12.56 If an external investment pool issues a separate report, GASB Statement No. 31, paragraph 19, requires the sponsoring government to describe in the notes to the financial statements how to obtain that report. If an external investment pool does not issue such a report, the sponsoring government’s notes to the financial statements should include certain disclosures, including, for example, condensed statements of net assets and changes in net assets for each pool. The presumption in this disclosure requirement is that the separate pool report conforms with GAAP. An unqualified auditor’s opinion on

¹⁷ The external portion of an external investment pool is the portion that belongs to legally separate entities that are not part of the sponsoring government’s financial reporting entity. The internal portion of each external investment pool is the portion that belongs to the primary government and its component units and should be reported as assets in those funds and component units.

the pool's separate report could provide evidence of conformity with that requirement. If a pool's separate report is not presented in conformity with GAAP, the sponsoring government does not qualify to limit its disclosure of pool information to a reference to the separate report.

12.57 Other chapters of this Guide, in particular Chapter 5, discuss audit objectives, internal control features, and audit procedures that would be appropriate for audits of governmental external investment pools. In selecting audit procedures, the auditor should be aware of the unique accounting and financial reporting requirements for such pools as well as the various compliance requirements that affect how they operate. Those compliance requirements may affect, for example, allowable investments, investment income allocation, and distributions and reports to pool participants. (See paragraph 12.10 concerning the auditor's responsibility for compliance requirements in a financial statement audit.) The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of governmental external investment pools, as discussed in paragraph 12.09. Further, the accounting and financial reporting guidance in the AICPA Audit and Accounting Guides *Audits of Banks and Savings Institutions*, *Audits of Credit Unions*, *Audits of Investment Companies*, and *Brokers and Dealers in Securities* do not constitute category (b) accounting and financial reporting guidance for governmental entities because the AICPA did not make those Guides applicable to those entities and the GASB did not clear them. However, even though those Guides are not applicable to governmental entities, auditors should consider referring to them for specific auditing considerations relating to external investment pools (such as, for example, audit procedures relating to cash and investments). Note that the AICPA anticipates publishing, in late 2002, the Audit and Accounting Guide *Financial Institutions*, which will combine and redraft chapters from the existing AICPA Guides for *Banks and Savings Institutions*, *Credit Unions*, and *Finance Companies*.

Colleges and Universities

12.58 Many college and universities are governmental entities. Some governmental (public) colleges and universities are part of the legal entity of a state or local government,¹⁸ whereas others are primary governments, stand-alone governments, or component units of a primary government. (Chapter 3 discusses the definition of the financial reporting entity and financial reporting provisions of GASB Statement No. 14.) This section often uses the terms *public institutions* and *institutions* to refer to public colleges and universities. The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of colleges and universities, as discussed in paragraph 12.09.

Financial Reporting Requirements

12.59 GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, requires that public institutions apply the accounting and financial reporting standards of GASB Statement No. 34. A public institution that is not a legally separate entity should be reported within the fund structure of the government of which it is a part. A public institution that is a legally separate entity should report as a special-purpose government: (a) engaged only in business-type

¹⁸ Public college and universities that are part of the legal entity of a state or local government sometimes issue separate individual fund or departmental financial statements, as discussed in Chapter 14.

activities, (b) engaged only in governmental activities, or (c) engaged in both governmental and business-type activities, as discussed in paragraphs 12.04 through 12.07. Each institution should determine which of the three presentations is most appropriate to its activities. A primary government or other entity with financial reporting oversight responsibilities may require a particular financial statement presentation for public institutions. The auditor should evaluate whether a mandated financial statement presentation is in conformity with GAAP for a particular institution. An institution's other accounting and financial reporting policies or processes also may be mandated by other entities. For example, a primary government may require that a component unit institution report the expenses in its enterprise fund statements of revenues, expenses, and changes in fund net assets by function (for example, instruction, academic support, student services, and so forth), rather than by natural (object) classification (for example, salaries and wages, employee benefits, supplies, utilities).

12.60 If a legally separate institution reports as engaged only in business-type activities, it should present its activities using the three financial statements required for enterprise funds—a statement of fund net assets or balance sheet; a statement of revenues, expenses, and changes in fund net assets or fund equity; and a statement of cash flows.¹⁹ An institution's presentation of more than one enterprise fund is governed by NCGA Statement 1, paragraph 30, as amended, which indicates that individual funds are not required for financial reporting purposes unless required by legal or contractual provisions or by GAAP.

12.61 If a legally separate public institution is engaged only in governmental activities or engaged in both governmental and business-type activities, it should present both the government-wide financial statements and the applicable fund financial statements required by GASB Statement No. 34. (See the discussion of those financial statements in paragraphs 12.05 and 12.06 and Chapter 2.)

Internal Control and Compliance Requirements

12.62 Because of the unique characteristics of each public institution, it is not possible to suggest uniform or standard internal control. Further, internal control may not be the same across all units of a multi-campus or multi-institution system. Auditors should be familiar with an institution's internal control and evaluate the effect of that internal control on their audit procedures.

12.63 Public institutions usually are subject to various legal and contractual provisions that may affect their financial statements. For example, besides the financial reporting requirements discussed in paragraph 12.59, there may be compliance requirements relating to grants, appropriations from other governments, contributions, endowments, split-interest agreements, and debt issuances. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the institution's compliance with those requirements as part of the financial statement audit.

¹⁹ Although not required, GASB Statement No. 34, paragraph 123, encourages entities that report as engaged only in business-type activities also to present as supplementary information other than RSI, known as SI, a statement of activities (which is the government-wide activity statement as discussed in Chapter 2.). It also encourages entities to present such a statement of activities as SI for multiple-function enterprise funds if they want to present disaggregated data beyond what is required for segment reporting. (Chapters 4, "Planning the Audit," and 14 discuss the audit procedures and auditor's reporting for SI.)

Governmental and Private-Sector, Not-for-Profit Accounting and Financial Reporting Differences

12.64 There are various differences between the accounting and financial reporting standards for public institutions and those for not-for-profit institutions, many of which are highlighted in the following list. (This listing is provided to help auditors experienced with not-for-profit institutions. Auditors who are unfamiliar with not-for-profit standards do not need to understand those standards to understand the standards for public institutions.) Auditors should become familiar with governmental standards for public institutions as discussed in this section and elsewhere in this Guide.

- *Order of presentation of assets and liabilities.* Governmental standards require the enterprise fund statement of fund net assets to present assets and liabilities as current or long-term and the government-wide statement of net assets to present assets and liabilities based on liquidity or on current and long-term classifications. (See Chapter 2.) Not-for-profit standards require not-for-profit institutions to provide information about liquidity or maturity of assets and liabilities either in the statement of financial position or in the notes to the financial statements.
- *Accounting and financial reporting for specific types of transactions.* Governmental standards for certain types of transactions, such as investments, nonexchange transactions, pensions, and other post-employment benefits (see Chapters 5, 6, and 8), differ from not-for-profit standards.
- *Pell grants.* Under governmental standards, public institutions consider Pell grants to be pass-through grants and report the federal funds as revenues (see paragraph 12.67). Not-for-profit accounting does not treat third-party payments for services as contributions. Consequently, not-for-profit institutions treat Pell grants as agency transactions and do not report the federal funds as contribution revenue to the institution.
- *Promises to give (pledges).* Not-for-profit standards require the discounting of promises to give that are to be received over an extended period. Governmental standards neither require nor prohibit discounting. (See Chapter 6.)
- *Contributions made to other organizations.* Donors sometimes make contributions to one organization for the benefit of another organization. Not-for-profit standards require an institution that is the ultimate beneficiary of such a contribution to recognize the contribution and the asset held by the recipient organization under certain circumstances. There is no similar governmental standard. (See, however, the discussion of affiliated organizations in paragraph 12.86.)
- *Use of restricted net assets.* Not-for-profit standards require that when an expense is made for a purpose for which both unrestricted and temporarily restricted net assets exist, the expense should be charged to restricted net assets unless the expense is directly attributable to another specific external revenue source. Governmental standards require that restricted net assets be reported until the resources are used for the specified purpose. Even though governmental standards do not impose a “flow assumption” for purposes of expense recognition, a public institution’s management should establish a policy concerning whether to first apply specific expenses to unrestricted or restricted resources because governmental standards

require disclosure of that policy. (See the additional discussion of this provision of governmental standards in Chapter 6.)

- *The financial reporting of equity.* Governmental standards establish the following three components of net assets for presentation in government-wide and enterprise fund financial statements—(a) invested in capital assets, net of related debt, (b) restricted, and (c) unrestricted. Not-for-profit standards establish the following three classes of net assets—(a) permanently restricted, (b) temporarily restricted, and (c) unrestricted. Governmental standards require that restricted net assets be displayed separately for expendable and non-expendable restricted net assets and that the purpose of restricted net assets be displayed to some extent. Not-for-profit standards permit display of the purpose of temporarily restricted net assets, but alternatively permits those purposes to be disclosed in the notes to the financial statements. Governmental standards prohibit display of management designations of unrestricted net assets on the face of the financial statements but do not prohibit disclosure in the notes. Not-for-profit standards permit information about designations to be provided in notes to or on the face of the financial statements. (See the further discussion of the display of equity in Chapter 10, “Equity and Financial Statement Reconciliations.”)
- *Cash flows statements.* Governmental standards require that cash flows statements for enterprise funds be prepared using the direct method. Not-for-profit standards permit either the direct or indirect method. With the use of the direct method, governmental standards require a reconciliation from operating income to net cash flow from operating activities, whereas not-for-profit standards require the reconciliation to be from the change in net assets. Governmental standards specify four categories for reporting cash flows (see Chapter 2), whereas standards for not-for-profit institutions specify three categories. Although two of the categories (operating and investing) are named the same in governmental and not-for-profit standards, and governmental standards have two financing categories whereas not-for-profit standards only have one financing category, the cash flows reported within each category differ in several significant ways between governmental and not-for-profit standards.
- *Note disclosures.* Governmental standards require specific information in note disclosures that are not required by standards applicable to not-for-profit institutions, such as for cash and investments (see Chapter 5), capital assets (see Chapter 7), and long-term debt and segments (see Chapter 8). Similarly, standards applicable to not-for-profit institutions require specific information in note disclosures that are not required by governmental standards.
- *Required supplementary information.* Governmental standards require the presentation of an MD&A and other applicable RSI. (Chapter 2 discusses the GASB’s RSI requirements and Chapters 4 and 14 discuss the limited procedures and auditor’s reporting on RSI.) There are no RSI requirements for not-for-profit institutions.

Tuition and Fees

12.65 The 2nd GASB 34 Q&A, item 137, provides that revenues from tuition and student fees of an academic term that encompass two fiscal years—for example, a summer session—should be recognized partly in each year by accruing the amount earned each year.

Scholarship Discounts and Allowances

12.66 GASB Statement No. 34, footnote 41, requires proprietary funds (which include enterprise funds) to report revenues net of discounts and allowances with the discount or allowance amount parenthetically disclosed on the face of the statement of revenues, expenses, and changes in fund net assets or in a note to the financial statements. Alternatively, revenues may be reported gross with the related discounts and allowances reported directly beneath the revenue amount. That requirement applies to scholarship discounts and allowances that satisfy a student's tuition and fees, housing, meals, books, and other goods and services provided by the institution. For such discounts and allowances reported for governmental activities in the government-wide statement of activities, item 138 in the GASB 34 Q&A states that the same reporting requirements should be applied.

Pell Grants

12.67 Pell grants (Catalog of Federal Domestic Assistance [CFDA] program number 84.063) is an entitlement program funded by the federal government that is a major source of aid to college and university students. Institutions have administrative and direct financial involvement with Pell grants because they determine eligible secondary recipients (such as determining that students are enrolled in eligible programs and in the number of credit hours required for the level of awards) and are liable for disallowed costs. Therefore, under the provisions of GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, paragraph 5, institutions should report Pell grants as revenues.

Enterprise Fund Revenue and Cash-Flow Classifications

12.68 Paragraphs 12.69 through 12.74 discuss how institutions should classify certain resource inflows (a) as operating revenues, nonoperating revenues, or capital contributions in the enterprise fund statement of revenues, expenses, and changes in fund net assets and (b) as cash flows from operating, noncapital financing, capital and related financing, or investing activities in the enterprise fund statement of cash flows. Chapter 6 discusses the GASB Statement No. 34 standards for revenue classifications and disclosures, including how defining a proprietary fund's operating revenues and expenses should consider how individual transactions would be categorized for purposes of preparing a statement of cash flows. Chapter 2 discusses the requirements of GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

Research Grants and Contracts

12.69 Public institutions receive funding from various sources—the federal government, state and local governments, businesses, and individuals—for various purposes. As stated in the GASB 34 Q&A, item 214, revenues for which cash flows are reported as from operating activities likely also would be regarded as operating revenues. GASB Statement No. 9, paragraph 17c, provides that cash flows from operating activities include cash receipts from grants for specific activities that are considered to be operating activities of the grantor government, stating that a grant arrangement of this type is essentially the same as a contract for services. Therefore, revenue from research grants and contracts that meet the criterion for reporting as cash flows from

operating activities also generally should be reported as operating revenue. The auditor should consider the predominant characteristics and substance of research grants and contracts in evaluating how management has classified those amounts in the statement of cash flows and the statement of revenues, expenses, and changes in fund net assets.

State and Local Government Appropriations

12.70 Many public institutions receive appropriations from state or local governments. As provided in Chapter 6, nonoperating revenues generally should include revenues from appropriations between primary governments and their component units for operating purposes or that may be used, at the recipient's discretion, for either operating purposes or capital outlay.²⁰ Item 126 in the 2nd GASB 34 Q&A indicates that institutions cannot establish a policy to include state appropriations in operating revenues. The illustrative statement of cash flows in the nonauthoritative appendix D of GASB Statement No. 35 illustrates cash flows from appropriations as cash flows from noncapital financing activities and capital and related financing activities.

Federal Land Grant Income

12.71 In the past, the federal government provided land to certain institutions, including land grant institutions, to be used to generate funds for the institutions in perpetuity. Those assets provide support to the institutions through the investment of moneys from the sale of the land or income produced by the land through mineral or other rights. Those assets would be endowments if held by the institutions, but they usually are administered by a state land office or other governmental agency. There often are state statutes or other externally imposed restrictions on an institution's use of the income from those grants. The source of the revenues and any externally imposed restrictions on their use should be considered in determining the proper revenue classification in enterprise funds.

Third-Party Student Loans

12.72 Many students or their parents secure loans from a source other than the institution to assist with the cost of attending the institution. These are transactions between the students or parents and the lender, for example, a financial institution, the U.S. Department of Education, or a state loan program. Institutions receive funds from the lenders and then disburse funds to students or apply amounts to the students' accounts. These third-party transactions are not within the scope of GASB Statement No. 24 because they are not pass-through grants. There is no governmental standard that requires institutions to report the loan amounts received and disbursed as revenue. Institutions that report as engaged only in business-type activities and that have an accounting policy to report undisbursed loans at year-end as assets and liabilities in an enterprise fund statement of fund net assets should report the cash flows for these third-party student loans in the enterprise fund statement of cash flows. The GASB has provided no guidance concerning the appropriate category for reporting those cash flows. Some believe that reporting them as cash flows from noncapital financing activities is appropriate because the cash flows do not represent operating activities. Others note that

²⁰ Items 213 and 215 of the GASB 34 Q&A support this classification requirement. Those items also indicate that revenues that are restricted for the acquisition or construction of capital assets should be classified as capital contributions, reported separately after nonoperating revenues and expenses, not as nonoperating revenues.

cash flows from third-party loans are not listed in GASB standards as cash flows from capital and related financing, noncapital financing, or investing activities. They therefore believe that these cash flows should be reported as from operating activities based on GASB Statement No. 9, paragraph 17e, which specifies this category should include “all other cash receipts that do not result from transactions defined as capital and related financing, noncapital financing, or investing activities.”

Institutional Student Loans

12.73 As opposed to third-party student loans discussed in paragraph 12.72, institutions often make student loans from institutional funds and earn interest income from making those loans. Guidance related to classifying that interest income as operating or nonoperating revenue in the enterprise fund statement of revenues, expenses, and changes in fund net assets can be derived from GASB Statement No. 9, paragraph 19, which addresses classification for cash-flow purposes. Student loans from an institution’s funds are not intended to be investments, but are undertaken, instead, to fulfill a governmental responsibility. Because such “program loans” are made and collected as part of a governmental program and are part of the operating activities of the governmental enterprise, the related cash flows should be classified as operating activities. (The illustrative statement of cash flows in the nonauthoritative appendix D of GASB Statement No. 35 illustrates this classification.) Similarly, interest income on the loans should be reported as operating revenue. (The principal amounts of the loans made and collected are reported as balance-sheet transactions and do not affect the enterprise fund statement of revenues, expenses, and changes in fund net assets.)

*Investment Income on Endowment Resources*²¹

12.74 GASB Statement No. 9 requires cash inflows from investing activities (other than “program loans” as discussed in paragraph 12.73) to be classified in a category separate from cash flows from operating activities. Further, the GASB staff document *Guide to Implementation of GASB Statement No. 9 on Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting: Questions and Answers*, item 1, states that operating income typically excludes interest income. Thus, investment income on endowment resources generally should be classified as nonoperating revenues in the enterprise fund statement of revenues, expenses, and changes in fund net assets.²² GASB Statement No. 31 permits the change in fair value of investments to be presented separately or combined with other investment income as a single amount.

Government-Wide Revenue Classification

12.75 Often, a public institution that presents its financial statements using enterprise fund accounting and financial reporting standards also will present or be presented in a government-wide statement of activities. This would occur, for example, when a component unit institution is included in a reporting entity’s financial statements. In the statement of activities, revenues

²¹ See the discussion of endowments starting in paragraph 12.76.

²² The GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A), item 136, states that it is not appropriate to report investment income restricted to increase permanent or term endowments as “additions to permanent or term endowments.”

that are not presented as contributions to term or permanent endowments, contributions to permanent fund principal, or special or extraordinary items are presented as either program revenues or general revenues. As discussed in the GASB 34 Q&A, item 143, the distinction between operating and nonoperating revenues is not required to be made in the government-wide statement of activities. That item states that some nonoperating revenues satisfy the criteria to be reported as program revenues, whereas some may be reported as general revenues. It further states that capital contributions (which are reported separately of operating and nonoperating revenues in the proprietary fund financial statements) often would be reported as program revenues. Item 72 of the 2nd GASB 34 Q&A discusses the reporting of the change in fair value of investment as program or general revenues. When component unit public institutions do not present a government-wide statement of activities, their primary governments may require them to include government-wide revenue classification information in their basic financial statements so that audited information is available for the reporting entity's financial statements. Other governments will infer that information from the component unit financial statements as discussed in item 50 of the 2nd GASB 34 Q&A.

Endowments

12.76 Many public institutions have endowments, and the amounts may be large. The auditor needs to understand the legal and contractual provisions for endowments that could have a direct and material effect on the determination of financial statement amounts, which may involve understanding the types of endowments, the applicable state law, how the institution manages the investment of the amounts, how the institution decides how much of the revenue to spend currently, and the proper financial reporting of both the earnings and net assets. Institutions often define three types of endowments—permanent (or true) endowments, term endowments, and quasi-endowments. The following describes those three types of endowments and how their balances and activities are reported in enterprise funds. Paragraph 12.74 and footnote 22 discuss enterprise fund reporting of investment income on endowment resources.

- Permanent (or true) endowments are amounts for which donors or other outside entities have stipulated, as a condition of the gift instrument, that the principal is to be maintained in perpetuity. Terms of the gift instrument will stipulate how earnings on the endowment principal are to be used—either added to the endowment account, used for some specific restricted purpose, or used for unrestricted purposes. Net assets of permanent endowments should be reported as restricted and nonexpendable. Net assets resulting from earnings should be reported in a net asset category based on the stipulations in the gift instrument.
- Term endowments are similar to permanent endowments except that, upon the passage of a stated period of time or the happening of a particular event, all or a part of the principal may be expended. Terms of the gift instrument will stipulate how earnings are to be used. Net assets of term endowments should be reported as restricted and expendable (see the GASB 34 Q&A, item 98). Net assets resulting from earnings should be reported in a net asset category based on the stipulations in the gift instrument.
- Quasi-endowments (or funds functioning as endowments) are amounts that the institution's governing board, rather than a donor or other outside entity, has determined should be managed as if they

were a permanent or term endowment. (Those amounts may have come from unrestricted resources or from moneys that a donor or other outside entity restricted for use for a particular purpose.) Net assets should be reported as if the board had not designated the amounts as quasi-endowments. Thus, net assets should be reported as restricted and expendable or as unrestricted, depending on whether there are restrictions on the resources used to create the quasi-endowment.

12.77 A major issue concerning permanent and term endowments is whether the endowments are governed by trust law. The most significant consequence of the resulting conclusion is whether realized and unrealized appreciation on investments should be considered to increase the endowment balance or whether all or part of the appreciation may be expended the same as income. *Income* includes dividends, interest, rents, royalties, and the like but not gains from appreciation. The traditional legal view is that endowments are subject to treatment as trusts. Under classical trust doctrines, gains of endowment funds can only be added to principal and cannot be expended.

12.78 Most institutions today do not consider endowment funds to be governed by trust law. Advocates of this legal view hold that the trust law is inapplicable to endowment funds and that the concepts of corporate law are more applicable if the issues involved are administrative in nature, such as endowment investment management and allocation of gains to income or principal. The corporate law concept views the institution as the absolute owner of gifts with the obligation to include gains as income. Under the corporate law concept, the income beneficiary and remainderman are usually the same, whereas trust law demands a fair division between the income beneficiary and the remainderman (which are two distinct and sometimes antagonistic interests). Under trust law, gains traditionally have been kept for the remainderman. Support for not following trust law is found in the Uniform Management of Institutional Funds Act (the Uniform Act), which has been adopted in some form in most states. Other support is found in the Uniform Prudent Investors Act where that statute has been adopted. Those laws contain a standard of prudence and the governing board usually is required to determine how it will allocate earnings to spending and to maintaining the earning power of an endowment amount.

12.79 Most institutions have adopted what is usually referred to as a "total return" approach to endowment fund investment management. That approach emphasizes total investment return—traditional yield plus or minus gains and losses. Practically all total return approaches emphasize the use of "prudence" and a "rational and systematic formula" in determining the portion of gains that may be spent and call for the protection of endowment principal from the loss of purchasing power (inflation) as a primary consideration before spending gains. Total return approaches have many variations, including some provisions to eliminate extreme short-term fluctuations in the amounts that are allocated for spending. The total return approach does not change how earnings are reported. GASB standards neither require nor prohibit reporting earnings in more detail (for example, distinguishing between nonendowment and endowment investment income) either on the face of the statement of revenues, expenses, and changes in fund net assets or by note disclosure.

12.80 Paragraph 121 of GASB Statement No. 34 requires note disclosure of certain information about donor-restricted endowments, including the state law regarding the ability to spend net appreciation and the spending policy.

The spending policy or “spending rate” is the amount of the total return that the institution will make available for spending. State laws vary, even when based on the Uniform Act, and under many state laws, the trustees are required to exercise prudence in setting the spending rate. The GASB is silent on the spending rate other than requiring its disclosure.

Split-Interest Agreements

12.81 Public institutions often have split-interest agreements, which were at one time called annuity or life income agreements. Split-interest agreements include charitable gift annuity contracts, pooled life income trusts, charitable remainder unitrusts, charitable remainder annuity trusts, and charitable lead annuity trusts.²³ These agreements require careful attention to legal and tax issues. Individual agreements may contain specific provisions on permissible investments, permissible use of funds when the split-interest ends, or other matters. Often, some investments may be pooled with those of endowment accounts. However, in other cases, the provisions of agreements or the inherent objective of the investments dictate separate investments. In enterprise funds, earnings on the investment of these assets should be reported as nonoperating revenues. Determining the proper liability of these agreements is important. In enterprise funds, net assets usually should be reported as restricted and as expendable or nonexpendable based on the conditions attached to the agreement on how the institution can use the funds when the split-interest terminates. Item 133 in the 2nd GASB 34 Q&A discusses the reporting of split-interest agreements.

Expense Classifications

12.82 Item 211 in the GASB 34 Q&A explains that expense classification in the proprietary funds statement of revenues, expenses, and changes in fund net assets may be by natural (object) classification or by function. If an institution presents its enterprise fund statement of revenues, expenses, and changes in fund net assets using functional classifications, GASB standards neither require it to allocate nor prohibit it from allocating depreciation and operations and maintenance of plant (O&M) expenses to each function.

12.83 GASB Statement No. 34, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Omnibus*, requires the government-wide statement of activities to present activities accounted for in enterprise funds by “different identifiable activities.” (See the further discussion of that requirement in Chapter 2.) GASB Statement No. 37 states that determining whether an activity is *different* may require the use of professional judgment, but generally is based on the goods, services, or programs provided by an activity. It also states that for public institutions reported in enterprise funds, the variety

²³ These and other types of split-interest agreements are described in the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. Note that the accounting and financial reporting guidance for those agreements in *Not-for-Profit Organizations* does not constitute category (b) guidance for governmental entities because the AICPA did not make that Guide applicable to governmental entities and the GASB did not clear it. (See Chapter 1 for a discussion of the GAAP hierarchy for governments.) Further, as provided for in GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, paragraph 7, as amended by GASB Statement No. 34, when read together with the discussion in paragraph 33 in the nonauthoritative Basis for Conclusions of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, enterprise funds that apply post-November 30, 1989 FASB pronouncements should not apply AICPA pronouncements whose provisions are limited to not-for-profit organizations.

of activities common to those institutions (such as food service, bookstore, residence halls, and student unions) generally would not be required to be reported separately because those various activities might be considered incidental to the delivery of a common product or service—higher education.

Fund-Raising Costs

12.84 Many public institutions solicit support through fund-raising activities conducted in conjunction with activities related to other functions, such as program activities or supporting services. AICPA Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, included as Appendix C of this Guide, establishes accounting and financial reporting standards for the costs of joint fund-raising and program activities.²⁴ It also requires disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Although that SOP applies to all governments, its provisions are only meaningful for entities that report using functional classifications.

Fund-Raising Costs

12.85 GASB Statement No. 34, as amended by GASB Statement No. 37, requires governments that report enterprise funds or that use enterprise fund accounting and reporting standards to make certain segment disclosures in the notes to the financial statements relating to certain debt-financed activities. (See the further discussion of those requirements and the definition of segments in Chapter 8.) GASB Statement No. 37 clarifies that a segment is an identifiable activity or a grouping of activities and, thus, reinforces the guidance in the GASB 34 Q&A, item 236, which discusses how segment disclosures are made for an public institution's revenue debt-financed residence halls.

Affiliated Organizations

12.86 In certain situations, public institutions may be required by GASB standards to include information about certain other legally separate organizations in their financial statements, often by presentation as component units. This may affect, for example, research foundations, fund-raising foundations, and university hospitals (as well as their medical practice plans). See the discussion of GASB Statement No. 14, *The Financial Reporting Entity*, as amended, in Chapter 3.²⁵

Federal Unrelated Business Income Taxes

12.87 Governmental colleges and universities and their wholly owned subsidiary corporations are subject to federal unrelated business income taxes (UBIT), which is a tax on income derived from any trade or business that is regularly carried on and not substantially related to the organization's tax-exempt purpose or function. See the discussion of UBIT in Chapter 8.

²⁴ SOP 98-2 was cleared by the GASB and includes governmental entities in its scope, and thus is category (b) guidance for governmental entities. See the discussion of the governmental GAAP hierarchy in Chapter 1.

²⁵ GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, amends GASB Statement No. 14, *The Financial Reporting Entity*, to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. The provisions of GASB Statement No. 39 are effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged. See the further discussion in Chapter 3, "The Financial Reporting Entity."

Specific Guidance for Recognized Indian Tribes

12.88 Recognized Indian tribes are sovereign entities, and the federal government considers them to be similar to state governments. Although some recognized Indian tribes do not meet the definition of governmental entities in Chapter 1 of this Guide, they generally use governmental accounting and financial reporting guidance to prepare their financial statements. Under GASB standards, recognized Indian tribes usually are considered primary or stand-alone governments and, because they provide various services as would a general-purpose government, should present both government-wide and fund financial statements (see paragraph 12.05 and Chapter 2). The auditor should apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of recognized Indian tribes, as discussed in paragraph 12.09.

12.89 Although some recognized Indian tribes have the power to enact and enforce tax levies, many tribes rely heavily on federal funding. Recognized Indian tribes often conduct HUD-financed housing programs; see the discussion in this chapter about public housing authorities. Indian tribes also often operate gaming activities and other business activities that meet the criteria in GASB Statement No. 34, paragraph 67, requiring the use of enterprise funds (as discussed in Chapter 2). If those criteria are not met, the activities may be reported in either governmental or enterprise funds. The accounting and financial reporting guidance in the AICPA Audit and Accounting Guide *Audits of Casinos* does not constitute category (b) accounting and financial reporting guidance for gaming activities operated by recognized Indian tribes that use governmental accounting and financial reporting guidance to prepare their financial statements because the AICPA did not make that Guide applicable to governmental entities and the GASB did not clear it. (See Chapter 1 for a discussion of the GAAP hierarchy for governments.) However, even though that Guide is not applicable to governmental entities, auditors should consider referring to it for specific auditing considerations relating to gaming activities operated by those recognized Indian tribes. In addition, the auditor should be familiar with the federal and state laws that govern the types of gaming and other activities that a tribe may conduct. As discussed in paragraph 12.10, the auditor should consider whether it is necessary to evaluate the tribe's compliance with those requirements as part of the financial statement audit.

Specific Guidance for State Governments

12.90 Generally, state governments are large operations, having assets and operations amounting to billions of dollars. The following discussion includes a number of accounting, financial reporting, and auditing considerations relating to state governments. Although some of those considerations also may affect local governments, they are more commonly associated with state governments.

Nature and Organization of State Governments

12.91 State governments are sovereign entities, with powers that are limited by their individual constitutions, the powers reserved exclusively for the federal government by the U.S. Constitution, and the rights guaranteed to citizens by amendments to the U.S. Constitution. Subject to those limitations, states can enact, repeal, and modify laws relating to the conduct of economic, political, social, and individual activities. All other governmental entities within a state exist as consequences of general or specific authorizations from

the state government and are accorded only those powers provided for in such authorizations. State governments have implicit powers, while subordinate governments created by states generally are limited to the powers expressly provided to them by the state or not expressly reserved for the state and, in some cases, not expressly prohibited.

12.92 To meet the varying needs of citizens, states have established various forms of state agencies and departments, regional governments, local governments, and special-purpose governments. The extent and nature of those organizations affect the structure of service delivery and the state financial reporting entity and, thus, the audit approach.

12.93 States usually operate on a highly decentralized basis. Given their numerous and varied activities, most states have established accountability centers under the control of an elected or high-level appointed official (usually a state comptroller or treasurer). In many cases, such centers' responsibilities are limited to appropriated funds. Consequently, such accountability centers normally do not maintain accountability for a state's component units or for certain large or autonomous agencies or departments (such as highway departments or state universities) that finance their operations primarily through user fees and purpose-restricted grants and contributions. In addition, in some states, the accountability centers do not maintain accountability for the operations of the offices of certain statewide elected officials or the state's legislative or judicial branches. When a state's centralized accountability center does not maintain accountability for certain component units, agencies, departments, or officials, those component units and other organizations maintain their own accounts and manage their own financial affairs, either with or without oversight from the accountability center.

12.94 Auditors should be aware of the possibility that numerous accounting systems, with varied internal control, can exist within state governments and should determine the extent to which such systems need to be evaluated for their effects, if any, on audit procedures. Auditors also should be aware of possible conflicts among the state officials with accounting responsibilities and consider whether the appropriate individuals are included in planning the audit, advised of audit progress, and provided opportunities to respond to draft reports.

Specialized Reporting Requirements

12.95 Accounting and reporting requirements for state governments may extend beyond GAAP. For example, state statutes may mandate certain additional financial summaries. Management should determine the existence and specifics of such requirements, including the need for auditor involvement, possibly through discussions with representatives of the offices of the state's attorney general, treasurer, comptroller, and auditor.

Reporting Entity Definition

12.96 Determining a state's financial reporting entity often is difficult because of the number, diversity, and autonomy of state component units, the existence of financially independent agencies and departments, and decentralized accounting systems. States also tend to be involved in more joint ventures than are local governments. Chapter 3 discusses the definition of the financial reporting entity and the related accounting and reporting under GASB Statement No. 14.

Separate Fund, Departmental, Agency, and Program Audits

12.97 Sometimes, separate audits of the financial statements of state funds, departments, agencies, and programs are performed, either as component elements of the audit of the state's financial statements or as completely separate efforts. Chapter 14 discusses those financial statements and illustrates auditor's reports for them.

Medicaid

12.98 Medicaid is a federal program that provides health care services to low-income persons. Medicaid services may be administered by states or through local governments on behalf of the states. In either case, health care providers (such as hospitals, physicians, nursing homes, and pharmacies), including governmental health care providers, are required to follow guidelines established by the state. Various methods and formulas are used to reimburse providers for services rendered, including the following:

- Hospitals and nursing homes may be reimbursed for the costs of rendering the services, with costs based on retrospective cost reports filed by the provider.
- Hospitals and other providers may be paid a predetermined (prospective) amount for each service rendered, based on the nature and complexity of the services.
- Nonhospital providers may be reimbursed based on the cost of the service (such as physician office visits and prescriptions) up to a maximum amount per service, or on a prospectively set rate that is based on the complexity of the type of service.

Some states make progress payments to providers, particularly hospitals, based on interim reports. Settlements may be made after the state's year-end, based on audited cost reports. Those settlements can result in either receivables from or payables to the providers.

12.99 The costs of Medicaid services are shared between the federal and state governments. In some states, local governments also share in the costs. Such sharing can vary by state and by the type of service rendered. The auditor should consider becoming familiar with the types of services provided and the cost-sharing arrangements and evaluating whether the federal and state (and local, if applicable) shares have been properly allocated and thereby properly reported in the financial statements. The auditor also should consider whether it is necessary to evaluate the state's compliance with other Medicaid requirements as part of the financial statement audit. (See paragraph 12.10.)

12.100 Governments that administer the Medicaid program should recognize revenue and expenses/expenditures using the provisions of GASB Statement No. 33, as discussed in Chapters 6 and 8. In many cases, Medicaid service providers may submit claims for payments well after year-end for services rendered before year-end. Such amounts are known as incurred but not reported (IBNR) amounts. The state may have to estimate the year-end IBNR amount payable to, or receivable from, providers. The state may estimate those IBNR amounts, for example, based on historical actual results that establish a reliable pattern, adjusted for known changes that affect that amount (such as increases in the reimbursement rate for particular services). The auditor ordinarily should evaluate whether such payables and receivables (and related expenses, expenditures, and revenues) are properly estimated and recorded at year-end, including whether revenue recognition in governmental funds considers "availability."

Food Stamps

12.101 Food stamps is a federal program that permits low-income persons to buy food. While some food stamps benefits are distributed through the use of paper coupons, most are distributed electronically through debit cards. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*,²⁶ provides guidance for how states should report food stamp transactions in the fund financial statements, requiring that they recognize distributions of food stamp benefits as revenue and expenditures in the general fund or a special revenue fund, whether the state distributes the benefits directly or through agents and whether the benefits are in paper or electronic form. Expenditures should be recognized when the benefits are distributed to the individual recipients by the state or its agents;²⁷ revenue should be recognized at the same time. States should report food stamp balances held by them or by their agents at the balance-sheet date as an asset offset by deferred revenue. Revenue, expenditures, and balances of food stamps should be measured based on face value. In the government-wide financial statements, food stamp-related balances and transactions should be measured using the economic resources measurement focus and the accrual basis of accounting. The auditor should consider evaluating whether food stamps balances and transactions are properly reported in the financial statements. The auditor also should consider whether it is necessary to evaluate the state's compliance with the federal government's program requirements as part of the financial statement audit. (See paragraph 12.10.)

Unemployment Compensation Benefit Plans

12.102 Unemployment compensation is a federal-state partnership program providing payments to eligible unemployed workers that is funded principally by "experience-rated" federal and state taxes on employers. GASB Statement No. 34 requires unemployment compensation benefit plans to be reported as enterprise funds because the employer taxes are considered exchange-like or insurance transactions. NCGA Interpretation 9, *Certain Fund Classifications and Balance Sheet Accounts*, provides that the administrative costs related to a state's unemployment compensation program should be included in the general fund unless legal provisions require it to be reported in another fund. The 2nd GASB 34 Q&A, item 95, states that such administrative activity should not be reported in the unemployment compensation enterprise fund. One significant accounting and financial reporting consideration relating to unemployment compensation plans may concern the calculation of the benefit liability and disclosure of additional contingencies. (Chapter 8 discusses the accounting, financial reporting, and auditing for contingent liabilities.) The auditor also should consider whether it is necessary to evaluate the state's compliance with the federal government's program requirements as part of the financial statement audit. (See paragraph 12.10.)

Lotteries

12.103 Most states conduct lotteries individually or through a multi-state arrangement. Lottery activities may be (a) part of the state's legal entity²⁸ or

²⁶ GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, does not apply to food stamps.

²⁷ GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, states that food stamp benefits are distributed in electronic form when the individual recipients use the benefits.

²⁸ Lotteries that are part of a state's legal entity sometimes issue separate fund or departmental financial statements, as discussed in Chapter 14.

(b) a legally separate entity that may be a component unit of the state. Lottery activities generally meet the criteria in GASB Statement No. 34, paragraph 67, requiring the use of enterprise funds (as discussed in Chapter 2). If those criteria are not met, the lottery activity may use either governmental fund or enterprise fund accounting and financial reporting. The auditor ordinarily should evaluate whether the financial statement amounts for lottery activities are properly measured and reported. The auditor also should consider whether it is necessary to evaluate the state's compliance with legal and contractual provisions that affect the financial statements, such as legal provisions relating to the use of lottery revenues. (See paragraph 12.10.)

12.104 Lottery prize costs normally should be accrued based on a percentage of ticket sales revenues. For example, if a lottery game is designed so that forty percent of ticket sales is paid out as prizes, prize costs of forty cents should be accrued for each dollar of revenue recognized for ticket sales. Accounting and financial reporting considerations may arise relating to (a) prizes won and claimed but not yet paid, (b) prizes won but not yet claimed, and (c) games-in-progress at year-end, as discussed in paragraphs 12.105 and 12.106.

12.105 Prize winners generally can choose to have large prizes paid to them (a) currently at present value in a lump sum or (b) over a period of years at future values. If the periodic payment option is used, the state may finance the prize liability, for example, by purchasing (a) an annuity from an insurance company or (b) U.S. Treasury securities matched in timing and amount to the future payments. If a purchased annuity is in the name of the prize winner, the state should not recognize a liability or asset because it has discharged the primary liability. However, the state may need to disclose in the financial statements that a contingent liability exists. (Chapter 8 discusses the accounting, financial reporting, and auditing considerations for contingent liabilities.) Further, if the state does not purchase an annuity in the name of the prize winner, any assets specifically identified to pay the liability (such as U.S. Treasury securities matched in timing and amount to the future payments) and the present value of the liability should be included in the state's financial statements.

12.106 The prize liability (measured using present value) should include lottery prizes that have been won but not yet claimed as well as anticipated prizes for games-in-progress at year-end. In addition, the gain contingency guidance of FASB Statement No. 5, *Accounting for Contingencies*, should be used to account for prizes that will be forfeited because the winners will not claim them within the required time frame.

12.107 Lottery tickets generally are sold in stores and other designated locations through both on-line computer access to the state lottery agency and "instant" games that use paper tickets. The state should estimate the amounts receivable from sales locations for lottery tickets, adjusted for an allowance for uncollectible receivables. The auditor should consider evaluating the reasonableness of those estimates.

12.108 Often, state law requires a certain percentage of lottery sales revenues to be used for particular programs, such as elementary and secondary education or services to the elderly. The GASB 34 Q&A, item 133, indicates that such lottery sales revenues should be reported as program revenues of the lottery function, not of the function that the revenues support. That guidance is supported by GASB Statement No. 37, paragraph 12, which states that for identifying the function to which a program revenue pertains, the determining factor for charges for services is which function generates the revenue.

Escheat Property

12.109 Escheat property is property that eventually reverts to a government (usually a state) because legal claimants or heirs have not been identified. Many state laws provide that a rightful owner or heir can reclaim escheat property (or its value) into perpetuity. Because large portions of escheat property are never reclaimed, most states use some of that property to finance operations.

12.110 GASB Statement No. 21, *Accounting for Escheat Property*, as amended by GASB Statements No. 34 and No. 37, contains the standards for reporting escheat property. In addition, when transactions involving escheat property are nonexchange transactions, the provisions of GASB Statement No. 33 apply to the recognition of assets, revenue, liabilities, and expenditures/expenses. GASB Statement No. 37 states that escheat property generally should be reported as an asset in the governmental or proprietary fund to which the property ultimately escheats. Escheat property held for individuals, private organizations, or another government should be reported in a private-purpose trust fund or in an agency fund, as appropriate, or in the governmental or proprietary fund in which escheat property is otherwise reported, with a corresponding liability. If reported in a governmental or proprietary fund, escheat revenue should be reduced and a fund liability reported to the extent that it is probable that the escheat property will be reclaimed and paid to claimants. The liability should represent the best estimate of the amount ultimately expected to be reclaimed and paid, giving effect to such factors as previous and current trends in amounts reclaimed and paid relative to amounts escheated, and anticipated changes in those trends. Payments to claimants should reduce the liability.

12.111 In the government-wide financial statements, escheat-related balances and transactions should be measured using the economic resources measurement focus and the accrual basis of accounting. However, such balances and transactions reported in private-purpose trust or agency funds should (like all fiduciary funds) not be reported in the government-wide financial statements.

12.112 The auditor should consider determining whether the government has established accounting policies for escheat property, including noncash escheat property, and applied them consistently. The auditor also should consider evaluating the government's support for its measure of the amounts payable to claimants.

State Tuition Programs

12.113 States administer Qualified State Tuition Programs (QSTPs), which permit participants to pay currently for or to save money towards future college costs in tax-advantaged programs. QSTPs are governed by the Internal Revenue Code (IRC) and generally fall into one of two categories: prepaid tuition plans and savings plans. With prepaid tuition plans, participants pay for years or units of education at current tuition rates and receive those years or units of education in the future even though tuition rates will have increased. With savings plans, participants save money in a special account that offers a variable rate of return and which may guarantee a minimum rate of return.

12.114 Although the IRC contains some basic requirements, each state-sponsored program varies and each state controls how contributions are to be

invested. Auditors should consider the need to evaluate a state's compliance with legal and contractual provisions governing the program. (See paragraph 12.10.) The fund type to use to report QSTPs depends on the facts and circumstances surrounding a particular program. However, the auditor ordinarily should evaluate whether the state has reported an estimated liability for future payments to or on behalf of plan participants that is appropriate to the financial statements in which the program is reported.

Multi-State Legal Settlements

12.115 States sometimes have common litigation against various parties, and settle that litigation jointly, often leading to large amounts of payments to be received over several years. The gain contingency provisions of FASB Statement No. 5 may apply in those situations. The auditor should be alert for those types of settlement payments and consider the terms of the settlement in evaluating a state's application of the provisions of FASB Statement No. 5.

Chapter 13

Concluding the Audit

Introduction

13.01 At or near the end of audit fieldwork, the auditor should perform certain procedures before issuing his or her report. This chapter addresses those procedures, which concern (a) evaluating misstatements and addressing audit adjustments, (b) requesting lawyer letters, (c) obtaining written representations from management, (d) evaluating related-party disclosures, (e) considering going concern considerations, (f) considering subsequent events, (g) performing analytical procedures, and (h) communicating with the audit committee and others.

Evaluating Misstatements and Addressing Audit Adjustments

13.02 The auditor should aggregate and evaluate misstatements in the context of individual opinion units. This is necessary because the auditor's report on the basic financial statements will provide separate opinions on each opinion unit. Also, professional standards concerning misstatements (such as management's representation concluding that uncorrected misstatements are immaterial and the auditor's communication to the audit committee about uncorrected misstatements) should be applied based on opinion units. (See the discussion of the concept of opinion units in planning, performing, and reporting on governmental audits in Chapters 4, "Planning the Audit," and 14, "Audit Reporting.")

13.03 Statements on Auditing Standards (SAS) No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* and SAS No. 96, *Audit Documentation*¹ (AICPA, *Professional Standards*, vol. 1, AU sec. 312.34–41), and Interpretations of AU Section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312), provide guidance in evaluating whether financial statements are fairly presented in all material respects in conformity with generally accepted accounting principles (GAAP). In evaluating misstatements, auditors should not rely exclusively on quantitative benchmarks to determine whether an item is material to the financial statements of an opinion unit. A numerical threshold may provide the basis for a preliminary assumption that an amount is unlikely to be material; however, it is not a substitute for a full analysis. Auditors also should consider qualitative aspects of misstatements. Qualitative factors that the auditor may consider relevant to his or her consideration for an affected opinion unit include the following:

- The potential effect of the misstatement on trends, for example, in revenue
- The effect of the misstatement on segment information

¹ Paragraph 13.05 and footnote 3 discuss the amendment made to SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, by SAS No. 96, *Audit Documentation*.

- The effect of the misstatement on quantitative materiality if quantitative materiality were calculated without reference to certain individual, large-dollar accounts, such as capital assets and long-term debt
- Misstatements that arise from estimates, allocations, or uncertainties
- The potential effect of the misstatement on the government's compliance with legal and contractual provisions, such as revenue misstatements that might affect the entity's compliance with bond covenants
- A misstatement that has the effect of increasing management's compensation, for example by satisfying requirements for the award of bonuses or other forms of incentive compensation
- The significance of the financial statement element affected by the misstatement
- The effects of misclassifications, for example, misclassification between operating and nonoperating revenues or restricted and unrestricted net assets
- The likelihood that a misstatement that is currently quantitatively immaterial may have a material effect in future periods because of, for example, a cumulative effect that builds over several periods
- The risk that possible additional undetected misstatements would affect the auditor's evaluation
- The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud, possible illegal acts, or conflicts of interest
- The motivation of management with respect to the misstatement, for example, (a) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (b) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process
- The significance of the misstatement or disclosures relative to politically sensitive matters or known user needs

13.04 Information essential for a fair presentation in conformity with GAAP includes information required to be disclosed in the notes to the financial statements. Misstatements that cause the financial statements not to be in conformity with GAAP include the omission of required financial statement disclosures and financial statement disclosures that are not presented in conformity with GAAP. The auditor should evaluate the adequacy of the note disclosures that accompany the basic financial statements in relation to the fair presentation of each affected opinion unit. That evaluation may require the auditor to exercise professional judgment to determine the opinion units affected by specific disclosures and disclosure requirements. If a particular disclosure requirement is limited to a particular reporting unit or financial statement, that is the context within which it should be evaluated. For example, certain disclosures about capital asset balances and activity are required for capital assets of the primary government reported in the government-wide statement of net assets. Thus, those disclosures would relate only to governmental activities and business-type activities if those opinion units have capital assets that are or should be reported. Broader disclosures, such as those required by Governmental Accounting Standards Board (GASB) Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, about deposits and investments, and GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, about the employer's required contribution

rate to a defined benefit pension plan, may relate to all opinion units in the basic financial statements. Auditors should evaluate both quantitative and qualitative factors in considering whether omitted or improperly presented note disclosures have a material effect on the affected opinion units.

13.05 The auditor should review the quantitative determination of major funds after all adjustments and reclassifications are made to the financial statements to determine whether all required major funds are separately displayed in the fund financial statements and have received appropriate audit coverage.² SAS No. 85, *Management Representations*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.06), requires the auditor to obtain written representations of management's belief that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. SAS No. 47, as amended by SAS No. 96 (AICPA, *Professional Standards*, vol. 1, AU sec. 312.40), requires the auditor to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated.³ SAS No. 61, *Communication With Audit Committees*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU sec. 380.10), requires the auditor to inform the audit committee or its equivalent about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. In a governmental audit, those provisions of SAS No. 85, as amended, SAS No. 47, as amended, and SAS No. 61, as amended, should be applied based on individual opinion units.

Requesting Lawyer Letters

13.06 Auditors should request lawyer letters to obtain corroboration of the information furnished by management concerning litigation, claims, and assessments (see SAS No. 12, *Inquiry Of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AICPA, *Professional Standards*, vol. 1, AU sec. 337]). The letters may be requested, for example, from inside counsel (such as a city attorney or the state attorney general) or from outside counsel. If inside counsel provides the assessment of litigation, claims, and assessments, the auditor should consider Interpretation No. 8, "Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments," of SAS No. 12 (AU Section 9337.24).

13.07 Occasionally, a government may not retain inside or outside counsel and may not have consulted a lawyer during the period about litigation, claims, or assessments. In those cases, the auditor should consider obtaining representations from management that no lawyers were consulted during the period, perhaps as part of the written representations discussed in paragraphs

² As discussed in Chapter 2, "Financial Reporting," a government is required to report certain governmental and enterprise funds as major in its fund financial statements based on quantitative criteria. Chapter 14, "Audit Reporting," discusses the effect on the auditor's report if a required major fund is not reported as such.

³ SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted.

13.08 through 13.11. When a lawyer is not consulted, the auditor has to rely on other audit procedures, including inquiries of government officials, and subsequent events procedures described below, to determine whether the government has appropriately reported and disclosed the existence of litigation, claims, and assessments. (See also Chapter 8, “Expenses/Expenditures and Liabilities,” for a discussion of the accounting, financial reporting, and auditing considerations for claims and judgments and commitments.)

Obtaining Written Representations From Management

13.08 SAS No. 85, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires the auditor to obtain written representations from current management on all periods covered in his or her report. SAS No. 85, as amended, includes a list of matters for which specific representations should be made, as well as an illustrative management representation letter and an appendix containing additional representations that may be appropriate to include in a management representation letter. The following are among the types of representations required by SAS No. 85, as amended, that are particularly important in a governmental engagement:

- Management has identified and disclosed to the auditor violations (and possible violations) of laws, regulations, and provisions of contracts and grant agreements with effects that should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. (See the discussion of the GASB requirements for disclosure relating to material violations of finance-related legal and contractual provisions and the auditor’s responsibility with regard to those disclosure requirements in Chapter 4, “Planning the Audit.”)
- Management has considered the uncorrected financial statement misstatements aggregated by the auditor and has concluded that any unadjusted differences are not material, both individually and in the aggregate, to the financial statements for each opinion unit.

13.09 SAS No. 85, as amended, also states that the representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity’s business or industry. Consequently, depending on the circumstances and professional judgment, the auditor of a governmental entity should consider obtaining representations from management that include the following:⁴

- Management is responsible for compliance with laws, regulations, and provisions of contracts and grant agreements applicable to the entity (for example, tax or debt limits and debt covenants).
- Management has identified and disclosed to the auditor laws, regulations, and provisions of contracts and grant agreements that could have a direct and material effect on financial statement amounts, including legal and contractual provisions for reporting specific activities in separate funds.⁵

⁴ SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, discusses additional management representations that the auditor should consider obtaining in a single audit (see Appendix D of this Guide).

⁵ Chapter 4, “Planning the Audit,” discusses the auditor’s responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements arising from violations of compliance requirements that have a direct and material effect on financial statement amounts.

- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management has followed applicable laws and regulations in adopting, approving, and amending budgets.
- The financial statements include all component units as well as joint ventures with an equity interest, and properly disclose all other joint ventures and other related organizations.
- The financial statements properly classify all funds and activities.
- All funds that meet the quantitative criteria in GASB Statement No. 34 for presentation as major are identified and presented as such and all other funds that are presented as major are particularly important to financial statement users.
- Net asset components (invested in capital assets, net of related debt; restricted; and unrestricted) and fund balance reserves and designations are properly classified and, if applicable, approved.
- Provisions for uncollectible receivables have been properly identified and recorded.
- Expenses have been appropriately classified in or allocated to functions and programs in the statement of activities, and allocations have been made on a reasonable basis.
- Revenues are appropriately classified in the statement of activities within program revenues, general revenues, contributions to term or permanent endowments, or contributions to permanent fund principal.
- Interfund, internal, and intra-entity activity and balances have been appropriately classified and reported.
- Special and extraordinary items are appropriately classified and reported.
- Deposits and investment securities are properly classified in category of custodial credit risk.
- Capital assets, including infrastructure assets, are properly capitalized, reported, and, if applicable, depreciated.
- If the modified approach is used to account for eligible infrastructure assets, the entity meets the GASB-established requirements for doing so.
- Required supplementary information (RSI) is measured and presented within prescribed guidelines.

Other industry- or entity-specific representations may be needed, depending on the particular facts and circumstances.

13.10 An auditor should obtain representations from those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others in equivalent positions. In a governmental audit, it often is desirable also to obtain representation letters from other officials (for example, asking the recording secretary for the governing board to represent that the minutes are complete for all meetings held during the period and through the date of the auditor's report).

13.11 As indicated in paragraph 13.08, SAS No. 85, as amended, requires the auditor to obtain written representations from *current* management. SAS No. 85, as amended, discusses auditors' responsibilities for obtaining written

representations in an audit engagement when current management was not present during the period under audit. It may be difficult for the auditor to obtain a representation letter if the responsible administrative officer was not in that position during the audit period. For example, a newly elected official may not be willing, or able, to sign representations relating to a period before the beginning of his or her term of office unless that official obtains supporting representations from other key officials who were responsible for financial matters during the audit period. SAS No. 85, as amended, states that management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement.

Evaluating Related-Party Disclosures

13.12 Chapter 4 provides examples of related parties in a governmental audit. The primary accounting and auditing focus for related parties is adequate presentation and disclosure in the financial statements. National Council on Governmental Accounting (NCGA) Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 5, requires disclosure of related-party transactions for all governments. In addition, GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 128, requires disclosure, for each major component unit, of the nature and amount of significant transactions with the primary government and other component units. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, which applies to the government-wide and proprietary fund financial statements, requires the specific disclosures below.⁶ By reference to FASB Statement No. 57, the same disclosures are required by SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties" (AICPA, *Professional Standards*, vol. 1, AU sec. 334.11–.12, "Disclosure"):

- The nature of the relationship(s) involved
- A description of the transactions, including transactions to which no amount or nominal amounts were ascribed, and such other information deemed necessary to understand the effects of the transactions on the financial statements
- The dollar amounts of transactions for each of the periods for which results of operations are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- Amounts due from or to related parties as of the date of each financial position statement presented and, if not otherwise apparent, the terms and manner of settlement

NCGA Interpretation 6, paragraph 5, does not indicate specific information that should be included in the related-party disclosure. However, to meet the requirements of NCGA Interpretation 6, paragraph 5, for governmental and fiduciary funds, the information provided for in FASB Statement No. 57 could be presented.

⁶ Chapter 2 discusses the applicability of certain private-sector pronouncements to the government-wide and proprietary fund financial statements. The specific disclosures from FASB Statement No. 57, *Related Party Disclosures*, listed in this paragraph have been revised to use terminology that is appropriate to governmental financial statements.

13.13 The auditor should consider applying procedures throughout the audit to determine the adequacy of presentation and disclosure of related-party transactions. See SAS No. 45 (AU Section 334.04–.06). Chapter 4 discusses the need for the auditor to perform procedures to identify related-party transactions during audit planning. Substantive procedures might include testing whether individual items are related-party transactions and whether they are properly disclosed. When concluding the audit, the auditor should consider whether the results of procedures applied during the audit indicated the existence of related-party transactions that require reporting.

Considering Going Concern Considerations

13.14 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 341), requires the auditor to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. It also provides guidance on (a) the auditor's evaluation of whether there is substantial doubt about the entity's ability to continue as a going concern, (b) the adequacy of financial statement disclosure, (c) the need to modify the auditor's report, and (d) audit documentation concerning the auditor's going concern evaluation.⁷ Ordinarily, a government's financial statements are prepared based on the assumption that the government will continue as a going concern. SAS No. 59, as amended, states that, ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. In a governmental audit, the auditor should make the going concern evaluation for the entity as a whole, not for individual opinion units.

13.15 Some have held the position that many governments are not subject to the factors that might threaten the future existence of a business enterprise. That position is largely attributed to an assumption that governments have the power to assess and levy taxes (and other charges) sufficient to finance operations and to service long- and short-term debt. However, some governments have constitutional or statutory limits on their taxing powers. Further, the ability to generate revenues, even if unlimited by law, can be limited by the incomes and resources of taxpayers. In the past, economic events and developments (such as significant investment losses) also have raised questions about whether certain governments are able to sustain operations. Although rare, some governments have declared bankruptcy. Therefore, as required by SAS No. 59, as amended, the auditor should evaluate the government's ability to continue as a going concern.

13.16 Examples of conditions or events that may indicate substantial doubt about a government's ability to continue as a going concern are as follows:

- Continuing significant fund balance or net asset deficits, or a pattern of annual operating deficits

⁷ The requirement for audit documentation concerning the auditor's going concern evaluation (AICPA, *Professional Standards*, vol. 1, AU sec. 341.17) arises from SAS No. 96, which is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted.

- Extremely high estimated liability for actual or incurred-but-not-reported (IBNR) claims for uninsured risks, including large adverse legal decisions or settlements
- Higher anticipated costs on construction and similar long-term projects than the entity can reasonably finance given current economic conditions
- Burdensome pension plan liabilities combined with diminishing revenues
- Potential for large tax refunds because of, for example, taxpayers' challenges
- Declining tax or other revenue base because of, for example, property value reassessments, one or more large taxpayers relocating out of the government's jurisdiction, competitive changes (such as consumer choice for electric utility services), or a recessionary economy
- Unwillingness of government officials to pay legally incurred liabilities
- Unwillingness of other governments to continue funding programs at existing levels
- Large investment losses
- Bond rating lowered below investment grade
- Debt covenant violations
- Major disasters such as earthquakes, floods, fires, or terrorist acts
- Tax rate at or near the legal limit
- Excessive use of short-term borrowing to reduce cash shortages, including tax and revenue anticipation notes
- Long-term borrowing to eliminate deficits or to meet current operating needs

13.17 SAS No. 59, as amended, indicates that if, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, he or she should consider management's plans for dealing with the adverse effects of the conditions and events. The auditor should obtain information about the plans and consider whether it is likely that the adverse effects will be mitigated for a reasonable period of time and that such plans can be effectively implemented. In a governmental audit, the auditor also should consider whether other governments have a legal or moral responsibility to subsidize or otherwise provide financial support to the government being audited. Those subsidies could affect the auditor's evaluation of the likelihood that the government being audited might, for example, default on debt or be unable to meet pension costs or other obligations, support activities that are incurring large deficits, or support present operating levels.

13.18 The auditor should evaluate whether conditions or events that indicate there could be substantial doubt about the government's ability to continue as a going concern, such as those described above, were noted during the audit up to the date of the auditor's report. In addition to standard audit procedures that may identify such conditions and events, procedures that are unique or significant in government may include the following:

- Reviewing compliance with the terms of debt, loan, and grant agreements
- Reading minutes of meetings of the governing board or any other administrative board with management oversight
- Confirming with related and third parties the details of arrangements to provide or maintain financial support

13.19 See SAS No. 59, as amended, for additional guidance on the effect of the auditor's consideration of going concern on the financial statements, the notes to the financial statements, the auditor's report, and audit documentation.

Considering Subsequent Events

13.20 Subsequent events are those that take place after the financial statement date but before the basic financial statements and auditor's report are issued. For a discussion, see AU Section 560, *Subsequent Events*, in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). Subsequent events consist of events or transactions that:⁶

- a. Provide additional evidence about conditions that existed at the financial statement date and affect the estimates inherent in preparing financial statements.
- b. Did not exist at the financial statement date but arose subsequent to the date, but nevertheless, are of such a nature that they should be disclosed to prevent the financial statements from being misleading.

13.21 The following lists includes examples of subsequent events that a government may experience. The size or other significance and timing of subsequent events will affect whether they should be reported in the financial statements or the notes thereto. The auditor should evaluate the reporting of subsequent events in relation to the fair presentation of the individual opinion unit(s) affected by the events:

- The filing or settlement of a lawsuit
- The issuance or defeasance of bonds or other debt instruments
- The award and acceptance of a grant
- The loss of grant funding or notice of potential disallowed costs
- Changes in the amounts or activities financed in the subsequent period's budget
- A change in the property tax base
- The imposition of an unfunded mandate
- A flood or other disaster that caused damage to the entity's infrastructure
- A renegotiated labor contract with the entity's employees

13.22 Subsequent events may be discovered as a result of audit procedures applied to specific financial statement elements for other audit objectives or through cutoff testing and assessment of asset and liability valuations. In addition to standard audit procedures to identify subsequent events, procedures that are unique or significant in government may include the following:

- Reading minutes of meetings the governing board, or any other administrative board with management oversight, held since the financial statement date
- Reading the subsequent years' capital and operating budgets
- Reviewing the description in the management's discussion and analysis (MD&A) of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations for items that represent subsequent events

⁶ This definition of *subsequent events* has been revised to use terminology that is appropriate to governmental financial statements.

Performing Analytical Procedures

13.23 In addition to their use in planning an audit, analytical procedures also should be used as part of an overall review of financial information in the final review stage of the audit. The objective of analytical procedures used in the overall review stage is to assist the auditor in assessing and documenting the conclusions reached and evaluating the financial statement presentation for each opinion unit. SAS No. 56, *Analytical Procedures*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures in the final review stage.^{9, 10}

Communicating With the Audit Committee and Others

13.24 SAS No. 61, as amended (AU Section 380), requires the auditor to determine that certain audit-related matters are communicated, orally or in writing, to the entity's audit committee or other formally designated group equivalent to an audit committee, such as a finance committee or a budget committee. If there is no such committee, the auditor of a governmental entity could consider making the required communication to the governing board. The specific matters to be communicated are listed in SAS No. 61, as amended. (See also Chapter 16, "Auditor Association With Municipal Securities Filings," for a discussion of SAS No. 61 as it relates to official statements that include audited financial statements.) In addition, other communications with the audit or equivalent committee or with management are required by SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317); SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325); SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801); and SAS No. 82¹¹ (AICPA, *Professional Standards*, vol. 1, AU sec. 316).¹² See the discussions of those other communication requirements in Chapter 4 and in the original pronouncements.

13.25 Many auditors also communicate other information to audit or equivalent committees or to management even though not required by generally accepted auditing standards (GAAS). That is, the auditor may observe and communicate through a "management letter" ways in which the entity could improve operational efficiency and effectiveness or otherwise improve internal

⁹ SAS No. 96 amends SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.22), for periods beginning on or after May 15, 2002 (with earlier application permitted), by requiring certain documentation when an analytical procedure is used as the principal substantive test of a significant financial statement assertion.

¹⁰ The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures.

¹¹ In February 2002, the ASB issued an Exposure Draft of a proposed Statement on Auditing Standards, *Consideration of Fraud In a Financial Statement Audit*, to supersede SAS No. 82. The final standard is expected to be issued by the end of 2002. For additional details, see the Auditing Standards Board-related information on the AICPA website at www.aicpa.org.

¹² *Government Auditing Standards* includes an additional field work requirement for communicating certain information to the auditee, the individuals contracting for or requesting audit services, and the audit committee during the planning stages of an audit. *Government Auditing Standards* also requires the auditor to (a) communicate to the auditee instances of fraud, illegal acts, and other noncompliance that do not meet the criteria for reporting in *Government Auditing Standards*, paragraph 5.18, and (b) report fraud and illegal acts directly to parties outside the auditee under certain circumstances. See SOP 98-3 (Appendix D of this Guide).

control or other policies or procedures (other than those for which communication is required by GAAS). For example, the auditor may become aware of inappropriate budgeting techniques or estimates. With declining support from higher levels of government, declining tax bases, and other economic factors, governments sometimes use unique budgetary practices that may be inappropriate or unachievable. Even though not required by GAAS (unless the techniques or estimates represent errors, fraud, or illegal acts), the auditor may want to communicate those observations and concerns to appropriate entity personnel.

Chapter 14

Audit Reporting

Introduction

14.01 Many governments are required to publish annual financial reports. Independent auditors often audit the financial statements in those reports. A government's management is responsible for the contents of the financial report. An independent auditor's primary responsibility is to report on whether the basic financial statements, including the notes thereto, are presented fairly in conformity with generally accepted accounting principles (GAAP).¹ The type of report the independent auditor issues depends primarily on the contents of the basic financial statements and on the scope and results of the audit.² This chapter discusses the auditor's report on governmental financial statements in various situations. Chapter 13, "Concluding the Audit," discusses the auditor's required communications with the audit committee and others.

14.02 The basic financial statements are the minimum financial statements that should be prepared under GAAP. The basic financial statements generally contain government-wide financial statements, fund financial statements, and notes to the financial statements. The basic financial statements should be accompanied by required supplementary information (RSI), which consists of management's discussion and analysis (MD&A) and, when applicable, other RSI.³ Chapter 2, "Financial Reporting," provides an overview of the form and content of the basic financial statements and RSI. Other chapters of this Guide provide more detail about certain aspects of those financial statements and RSI.

14.03 The auditor's primary responsibility is to report on the results of his or her audit of the basic financial statements. The auditor has additional responsibilities related to both RSI and to supplementary information other than RSI, known as SI. The auditor's responsibility for performing procedures on RSI and SI is discussed in Chapter 4, "Planning the Audit," and the auditor's responsibility for reporting on that information is discussed in paragraphs 14.48 through 14.61. The basic financial statements are designed to include all

¹ Auditor's reports on basic financial statements that are presented using a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), which are referred to as OCBOA financial statements, are discussed in Chapter 15, "Comprehensive Bases of Accounting Other Than Generally Accepted Accounting Principles." Auditor's reports on summary financial information in popular reports are discussed in paragraphs 14.68 through 14.75.

² Frequently, governments are required by law, regulation, agreement, contract, or policy to have their basic financial statements audited in accordance with *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States. Detailed guidance regarding Government Auditing Standards is contained in Statement of Position 98-3, *Audits of States, Local Governments and Not-for-Profit Organizations Receiving Federal Awards*, which is included in this Guide as appendix D.

³ As discussed in Chapter 2, "Financial Reporting," and Chapter 11, "The Budget," Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, permits governments to elect to report required budgetary comparison information in a budgetary comparison statement as part of the basic financial statements, rather than as required supplementary information (RSI).

information required for a fair and complete presentation in conformity with GAAP and may be issued without RSI or SI, although the omission of RSI will affect the auditor's report. Specific SI accompanies the basic financial statements in a Comprehensive Annual Financial Report (CAFR), as outlined in Chapter 2.

Materiality

14.04 The primary objective of the audit of financial statements is the expression of an opinion on the fairness with which they present, in all material respects, financial information as of the date and for the period identified in conformity with GAAP. As discussed in Chapters 4 and 13, auditors should plan, perform, and evaluate the results of audit procedures on a government's basic financial statements based on opinion units. Normally, the opinion units in a government's basic financial statements are (as applicable) the governmental activities; the business-type activities; the aggregate discretely presented component units; each major governmental and enterprise fund; and the aggregate remaining fund information (nonmajor governmental and enterprise funds, the internal service fund type, and the fiduciary fund types). As discussed in Chapter 4, in certain circumstances, auditors may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—into a single opinion unit. The resulting combined unit is referred to as the *aggregate discretely presented component unit and remaining fund information* opinion unit. The AICPA's fourth standard of reporting requires that the auditor's report contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. In reporting on a government's basic financial statements, the auditor's report generally should contain either expressions of opinion regarding the financial statements for each opinion unit, or assertions to the effect that an opinion on one or more opinion units cannot be expressed. Generally, the auditor expresses or disclaims an opinion on a government's financial statements taken as a whole by providing opinions or disclaimers of opinion on each opinion unit.

14.05 Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.05), states that "reference in the fourth reporting standard to the financial statements 'taken as a whole' applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant." A common example involves situations in which the auditor is unable to obtain sufficient competent evidential matter to support the opening equity balance shown in the activity statement. In that situation, the auditor might render an opinion on the financial position statement while disclaiming on the activity statement.

14.06 Applying the guidance in paragraph 14.05 to the auditor's report on a government's basic financial statements, the auditor may express an unqualified opinion on the financial statements of one or more opinion units and modified opinions or disclaimers of opinion on one or more of the other opinion units. Doing this constitutes separate opinions, not a "piecemeal opinion." (SAS

No. 58, as amended [AICPA, *Professional Standards*, vol. 1, AU sec. 508.64], defines *piecemeal opinion*.) However, as discussed in paragraph 14.10, there are situations in which an adverse opinion or disclaimer of opinion should be given for the government's basic financial statements taken as a whole.

14.07 The auditor's evaluation of the results of audit procedures that would lead to an opinion modification on one opinion unit may or may not result in an opinion modification on another opinion unit. For example, a GAAP departure may result in an opinion modification on a major governmental fund opinion unit. The auditor may conclude that the effect of that departure also has a material effect on the presentation of governmental activities and therefore also modify the opinion on the governmental activities opinion unit. On the other hand, the auditor may conclude that the effect of that departure does not materially affect governmental activities, and not modify the opinion on the governmental activities opinion unit for the departure. (See the illustrative auditor's report in appendix A, Example 14A.5.)

14.08 Similarly, the auditor may conclude that the effect of a GAAP departure has a material effect on, for example, the governmental activities opinion unit, but that the departure does not similarly affect the opinion units that include governmental funds. For example, if a government does not accrue material compensated absences liabilities relating to governmental activities, that nonaccrual may result in a modified opinion on the governmental activities opinion unit, but not directly affect the auditor's opinions on the opinion units that include governmental funds, which are not required to accrue those liabilities. (See the illustrative auditor's report in appendix A, Example 14A.7.) As discussed in Chapter 2, Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires reconciliations to the government-wide financial statements to be presented with the fund financial statements. In developing opinions on the opinion units, the auditor should view the financial statement reconciliations as relating to the presentation of the governmental activities and business-type activities opinion units, as discussed in Chapter 4.

14.09 As discussed in Chapter 4, the financial statements for some special-purpose governments engaged only in business-type activities (such as utilities) and for special-purpose governments engaged only in fiduciary activities (such as public employee retirement systems—PERS) will have a single opinion unit (provided the government has no discretely presented component units). Thus, the auditor will give a single opinion on those financial statements.⁴ In those situations, the auditor's report should contain either an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion on the financial statements taken as a whole cannot be expressed.

14.10 For entities with more than one opinion unit, certain egregious situations will result in the auditor expressing an adverse opinion or disclaimer of opinion on the financial statements taken as a whole:

- The auditor should express an adverse opinion on the financial statements taken as a whole when the required government-wide or fund financial statements are not presented.

⁴ Some special-purpose governments engaged only in business-type activities have more than one opinion unit, for example, because they have more than one enterprise fund or because they report fiduciary activities in fiduciary funds. Therefore, the auditor's report will provide more than one opinion.

- The auditor should express an adverse opinion on the financial statements taken as a whole when adverse opinions are appropriate for both the governmental activities and business-type activities opinion units (or for only the governmental activities opinion unit if that is the only required presentation for the primary government in the reporting entity's government-wide financial statements).
- The auditor should express a disclaimer of opinion on the financial statements taken as a whole when disclaimers of opinion are appropriate for both the governmental activities and business-type activities opinion units (or for only the governmental activities opinion unit if that is the only required presentation for the primary government in the reporting entity's government-wide financial statements).

Other situations occur in which adverse opinions or disclaimers of opinion on one or more opinion units are appropriate. In those situations, the auditor should use professional judgment to evaluate the facts and circumstances of those opinion modifications to determine whether the financial statement presentations on which he or she is considering issuing a modified report are of such a nature that the financial statements, taken as a whole, are not presented fairly in conformity with GAAP or if it is appropriate to disclaim an opinion on the financial statements taken as a whole.

14.11 As discussed in Chapter 4, the terms of an audit engagement may cause the auditor to set the scope of the audit and assess materiality at a more-detailed level than by the opinion units required for the basic financial statements (for example, at an individual fund or fund type level). Paragraphs 14.45 through 14.47 discuss auditor reporting in those situations.

Specific Issues in Reporting on the Audits of Governmental Financial Statements

Basic Financial Statements

Standard Report

14.12 The auditor's standard report on a government's basic financial statements states that the financial statements present fairly, in all material respects, the financial position, changes in financial position, and cash flows, where applicable, of each opinion unit in those financial statements in conformity with GAAP. (See paragraph 14.16 for a discussion of changes to the standard report if the basic financial statements contain a single opinion unit.) The basic elements of the standard report are listed in SAS No. 58, as amended (AU sec. 508.08). The form of the auditor's standard report on a government's basic financial statements covering a single year, with reporting on accompanying RSI and SI, is shown in appendix A, Example 14A.1.

14.13 The introductory paragraph of the auditor's report should refer to the audit of the financial statements of each opinion unit, even though some of those opinion units do not have distinct or separate financial statements. That is, for example, there usually will not be a single set of financial statements for the "aggregate remaining fund information." However, the reference in the introductory paragraph to the financial statements for the aggregate remaining fund information is meant to refer to the aggregate of the financial statements for the funds and fund types that comprise that opinion unit. The

introductory paragraph should identify the financial statements being audited. Usually, this identification includes reference to the table of contents or to the pages on which the financial statements are displayed. It is appropriate to refer to the table of contents only if the financial statements for which the reference is made are listed in the table of contents.

14.14 The introductory paragraph should state that the auditor's responsibility is to express *opinions* on the financial statements based on his or her audit. However, even though the auditor's report generally will provide more than one opinion, the auditor is conducting only one audit. Therefore, the scope paragraph refers to only one *audit*. If the government presents the required budgetary comparison information as a basic financial statement rather than as RSI (see Chapter 11, "The Budget"), the scope of the audit for the general and each major special revenue fund that has a legally adopted annual budget should encompass the required budgetary comparison information. The opinion paragraph should refer to the budgetary comparisons for those funds. (See footnote 2 in Example 14A.1.)

14.15 Usually, the introductory and opinion paragraphs of the auditor's report will refer in a general manner to the government's major funds, rather than separately naming individual major funds. This type of reference is appropriate if the major governmental and enterprise funds are evident from the basic financial statements (for example, if the financial statements, through labeling or disclosure, indicate which governmental and enterprise funds are major).⁵ When the major funds are evident from the basic financial statements, there is a presumption that the report users will be able to reasonably determine the major funds on which the auditor is opining. However, if the financial statements are ambiguous about which governmental and enterprise funds are major, the auditor should name those major funds in the report to make the scope of the audit and the opinions on the opinion units clear to the report user.

14.16 As discussed in paragraph 14.09, the financial statements for some special-purpose governments engaged only in business-type activities and for special-purpose governments engaged only in fiduciary activities will have a single opinion unit and, thus, the auditor will give a single opinion on those financial statements.⁶ See the illustrative auditor's report at appendix A, Example 14A.2. If, however, such a special-purpose government has one or more discretely presented component units, there will be more than one opinion unit. See the illustrative auditor's report at appendix A, Example 14A.3.

Departures From the Standard Report

14.17 SAS No. 58 explains that departures from the standard report occur in the case of qualified, adverse, and disclaimers of opinion on the basic financial statements. In addition, certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report. This section explains the types of conditions that may lead to

⁵ For example, the basic financial statements may include only one nonmajor enterprise fund and label all enterprise funds by name without indicating which enterprise funds are major and nonmajor. Item 82 in the GASB staff document *Guide to Implementation of GASB Statement No. 34 and Related Pronouncements: Questions and Answers* (2nd GASB 34 Q&A) states that the government should clearly distinguish between major and nonmajor funds and provides an example of how that can be accomplished.

⁶ See footnote 4.

an opinion modification and illustrates or refers to report language for those modifications. Specific situations that may require changes in the standard report language are discussed in paragraphs 14.26 through 14.47.

Scope Limitations

14.18 A lack of sufficient competent evidential matter or restrictions on the scope of the audit of the financial statements for an opinion unit may lead the auditor to qualify the opinion or disclaim an opinion on that unit. A scope limitation is present if a portion of a governmental reporting entity is not audited. A scope limitation that arises from a lack of sufficient competent evidential matter to support a financial statement assertion may involve circumstances in which, for example a government's accounting systems, processes, and records do not provide sufficient information to enable the government to:

- Report interfund activity and balances in the fund financial statements,
- Eliminate internal activity and balances in the government-wide financial statements, or
- Report capital assets in conformity with GAAP.

The auditor also should consider whether the entity's presentation constitutes a departure from GAAP. A scope limitation arising from insufficient evidential matter also could involve a situation in which an auditor is unable to obtain information about internal control over service organization services that are part of the government's information system.

Qualified Opinion—Scope Limitations

14.19 When a qualified opinion results from a limitation on the scope of the audit or insufficient evidential matter, the situation should be described in an explanatory paragraph preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. An example of a qualified opinion when a government does not obtain an audit of one or more (but not all) discretely presented component units that are material to the aggregate discretely presented component unit opinion unit, and the auditor determines that a qualification of opinion is appropriate, is shown in appendix A, Example 14A.4.

Disclaimer of Opinion—Scope Limitations

14.20 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements for one or more opinion units (or for the financial statements taken as a whole as discussed in paragraphs 14.10 and 14.21). A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements for the opinion unit or when the client imposes restrictions that significantly limit the scope of the audit. When disclaiming an opinion on an opinion unit because of a scope limitation, the auditor should state, in a separate explanatory paragraph preceding the opinion paragraph and referred to in the scope and opinion paragraphs, all of the substantive reasons for the disclaimer of opinion on the opinion unit. An example explanatory paragraph when one or more (but not all) discretely presented component units are not audited, and the auditor determines that a disclaimer of opinion is appropriate, is the same as that illustrated in appendix A, Example 14A.4, for a qualified opinion. (That example explanatory paragraph would require some modification if an auditor disclaims an opinion because all discretely presented component units are not audited.) Footnote 37 in Example 14A.4 illustrates a disclaimer of opinion on the aggregate discretely presented component units.

14.21 As discussed in paragraph 14.10, there may be situations in which, for entities with more than one opinion unit, the auditor will disclaim an opinion on the financial statements taken as a whole. In those situations, the auditor should state in a separate explanatory paragraph all of the substantive reasons for the disclaimer on the financial statements taken as a whole. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion and should not include a scope paragraph in the report. See the illustrative auditor's report in SAS No. 58, as amended (AU sec. 508.63).

Departures From GAAP

14.22 A departure from GAAP in the financial statements for an opinion unit may lead the auditor to qualify the opinion or express an adverse opinion on that unit. Some of the departures from GAAP that, depending on the materiality of the effect, would require an opinion modification for one or more opinion units include:

- Financial information, for example, for a fund, department, agency, or program, or one or more (but not all) component units, is omitted from the financial statements. (See the discussion concerning omitted component units in paragraphs 14.41 and 14.42.)
- A portion of the reporting entity does not apply GAAP, for example, a component unit is on a cash basis of accounting.
- General capital assets are omitted from the government-wide financial statements.
- The entity accounts for infrastructure assets using the modified approach even though it no longer qualifies to do so. (See the detailed discussion about the modified approach in Chapter 7, "Capital Assets.")
- The fund financial statements do not report one or more governmental or enterprise funds as major in conformity with the quantitative criteria of GASB Statement No. 34. (See paragraph 14.40.)
- A required note disclosure is omitted or is not presented in conformity with GAAP.

Qualified Opinion—Departures From GAAP

14.23 When the auditor expresses a qualified opinion, he or she should include a separate explanatory paragraph preceding the opinion paragraph that explains (a) all of the substantive reasons that have led him or her to conclude that there has been a departure from GAAP and (b) the principal effects of the subject matter of the qualification on the financial position, changes in financial position, or cash flows, where applicable, for the opinion units, if practicable, or a statement that the effects are not reasonably determinable. The opinion paragraph of the report also should include the appropriate qualifying language and a reference to the explanatory paragraph. A qualified opinion for a departure from GAAP is shown in appendix A, Example 14A.5.

Adverse Opinion—Departures From GAAP

14.24 An adverse opinion states that the financial statements for an opinion unit (or for the financial statements taken as a whole as discussed in paragraph 14.25) do not present fairly the financial position, changes in financial position, or cash flows, where applicable, in conformity with GAAP. When the auditor expresses an adverse opinion for an opinion unit, the auditor's report should include a separate explanatory paragraph preceding the opinion paragraph that makes the same explanations about the adverse opinion as discussed in paragraph 14.23 for a qualified opinion.

- An example of an adverse opinion on governmental activities because those financial statements do not include certain general infrastructure assets is shown in appendix A, Example 14A.6. The auditor should consider quantitative and qualitative factors in determining whether the omission of general infrastructure assets requires an opinion modification and, if so, whether the modification should be a qualified or an adverse opinion. Because a general-purpose government's general infrastructure assets are presumed to be material in relation to its governmental activities unless demonstrated otherwise, an adverse opinion usually would be appropriate. Such a presumption does not exist for special-purpose governments because some special-purpose governments, such as school districts, generally have little or no general infrastructure assets. Further, some auditors may conclude that the omission of general infrastructure assets cause the financial statements, taken as a whole, not to be presented fairly in conformity with GAAP.
- An example of an adverse opinion because a government does not accrue compensated absences liabilities and expenses for governmental activities is shown in appendix A, Example 14A.7.

14.25 As discussed in paragraph 14.10, there may be situations in which an adverse opinion(s) on the financial statements of an entity with more than one opinion unit will result in the auditor expressing an adverse opinion on the financial statements taken as a whole. An example of an adverse opinion when a government does not present government-wide financial statements is shown in appendix A, Example 14A.8.

Special Situations

Part of the Audit Performed by Another Auditor

14.26 There are many situations in which another auditor is involved in auditing a portion of a reporting entity. Usually involvement of another auditor relates to auditing component units. Chapter 4 discusses identifying the principal auditor and independence responsibilities in those situations. A principal auditor should consider the guidance in Chapter 4 concerning whether to assume responsibility for the work of another auditor and, thereby, whether to refer in the auditor's report to the work of the other auditor. When the principal auditor decides to refer to the audit of the other auditor, his or her report should indicate clearly, in the introductory, scope, and opinion paragraphs, the division of responsibility between that portion of the financial statements covered by the principal auditor's own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. Appendix A, Example 14A.9, illustrates a report that refers to the work of another auditor.

14.27 SAS No. 1, AU Section 543, "Part of Audit Performed by Other Independent Auditors" (AICPA, *Professional Standards*, vol. 1, AU sec. 543.11), states: "If the results of inquiries and procedures by the principal auditor . . . lead him to the conclusion that he can neither assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, nor report in the manner set forth in paragraph .09 [that manner illustrated in appendix A, Example 14A.9], he should appropriately qualify his opinion or disclaim an opinion on the financial statements taken as a whole. His reasons therefor should be stated, and the magnitude of the portion of the financial

statements to which his qualification extends should be disclosed." In an auditor's report on governmental financial statements, the opinion modification should relate to the opinion units involved.

14.28 Paragraph 14.61 discusses the effect on the principal auditor's report of another auditor's work on RSI and SI.

Subcontracting, Joint Audits, and Joint Ventures

14.29 An auditor occasionally performs an audit with another auditor, for example, a state auditor's office or a minority-owned or small firm. When another auditor is involved on a subcontract basis, only the principal auditor signs the auditor's report.

14.30 When the audit is performed on a joint basis, the auditors participating in the audit each sign the report in their individual capacities. AICPA standards do not provide for two or more auditors to divide the responsibility for an audit of the basic financial statements of a single entity. That is, each individual or firm signing an audit report is considered to be separately expressing the opinion(s) in the report. Each individual or firm that signs the report should have complied with generally accepted auditing standards (GAAS) as if they were the only signatory of the report.

14.31 A joint venture by two firms to conduct an audit takes the form of a legal entity, just as individuals band together to form a firm. In that situation, the audit report might be signed with the joint venture name. However, before using such an approach, the auditors should consider the implications of ethics rules on the use of fictitious names and state licensing statutes that may not recognize such an entity.

Preferable Accounting Policies

14.32 SAS No. 58, as amended (AU sec. 508.50), requires the auditor to evaluate management's justification for a change in accounting principles. In making such an evaluation, the auditor should consider whether the standards setter has identified a particular practice as preferable or encouraged.⁷ An accounting principle is preferable if the standards setter has identified it as such. If, instead, the standards setter has identified a principle as encouraged, that fact is considered in conjunction with other facts and circumstances (such as industry practice) in applying professional judgment to conclude whether an accounting principle is preferable. If a change is made to a less preferable method or without reasonable justification, and if the effect of the change is material, the auditor should express a qualified or adverse opinion for the affected opinion units. A change in a display principle would be less likely to be material than a change in a measurement or recognition principle. The auditor's consideration of and reporting on changes in accounting principles are discussed in SAS No. 58, as amended (AU sec. 508.50 through .57).

Prior-Period Financial Information

14.33 Sometimes, a government's basic financial statements include financial information from a prior period. This may be done in one of two ways: (a) a complete presentation or (b) a partial or summarized presentation.

⁷ Although GASB standards do not identify any alternatives as preferable, they do state or imply that the use of certain alternatives are encouraged. Appendix A, "Accounting and Financial Reporting Alternatives in GASB Statement No. 34, as Amended," of Chapter 2 lists certain accounting and financial reporting alternatives contained in GASB standards and identifies those that are encouraged. Certain private-sector standards applicable to governmental entities do identify preferable accounting and financial reporting alternatives as well as encouraged alternatives.

Complete Presentation of Prior-Period Financial Information

14.34 As discussed in Chapter 2, a complete presentation of prior-period financial information occurs when a government includes the complete basic financial statements from the prior period. That presentation may include additional information on the face of the current-period statements or may include both current-period and prior-period statements. In either case, the auditor should consider SAS No. 58 (AU sec. 508.65), as amended, which states:⁸

The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements taken as a whole applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor should update his report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.

14.35 If the prior-period financial statements include the minimum information required by GAAP for a complete set of financial statements, a continuing auditor should report on them.⁹ When complete comparative financial statements are presented and the auditor has not been engaged to audit the prior-period financial statements, the government may request the predecessor auditor to reissue his or her report. SAS No. 58, as amended (AU sec. 508.71–.73), provides guidance regarding such a reissuance. SAS No. 58, as amended (AU sec. 508.74) addresses the auditor's responsibility when the prior auditor's report is not presented.

Partial or Summarized Presentation of Prior-Period Financial Information

14.36 Partial or summarized presentations of prior-period comparative financial information result when the government presents less than the full basic financial statements from the prior period. (Chapter 2 discusses the display of and disclosure relating to such partial or summarized presentations.) This may be the result of including only some of the prior-period required financial statements or of including only a prior-period total column on a financial statement that requires multiple columns. SAS No. 58 (AU sec. 508.65, footnote 24) states the following:

A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund or net asset class, or the auditor would need to modify his or her report.

⁸ The auditor's consideration of this guidance from SAS No. 58 should be applied within the context of reporting on a government's financial statements based on opinion units as discussed in Chapter 4, "Planning the Audit," and earlier in this chapter.

⁹ See paragraph 14.56 for a discussion of comparative information in management's discussion and analysis (MD&A).

14.37 If prior-period financial information is a partial or summarized presentation (or a combination of partial and summarized information) and therefore does not include the minimum information required by GAAP for a complete set of financial statements, a continuing auditor's report should not mention the prior-period information in the description of the financial statements audited or in the opinion paragraph, although an explanatory paragraph may be needed, as discussed in paragraph 14.38. A continuing auditor should, however, make clear the degree of responsibility that he or she is assuming in relation to the prior-period information by stating in the introductory paragraph (a) that the partial or summarized information has been derived from a complete set of financial statements, (b) the date of the auditor's report on the complete financial statements,¹⁰ and (c) the type of opinions expressed.^{11,12} An example of such an introductory paragraph is the following:

Introductory paragraph: We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit. The prior year [*partial or summarized*] comparative information has been derived from the City's 20PY financial statements and, in our report dated September 15, 20PY, we expressed unqualified opinions on the respective financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information.

14.38 As discussed in Chapter 2, if the prior-period financial information does not include the minimum information required by GAAP, disclosure should be made about the nature of the information presented. The auditor should evaluate the adequacy of that disclosure. If the disclosure is omitted or incomplete, the auditor ordinarily should add a paragraph to his or her report calling the omitted or incomplete disclosure to the readers' attention. To reduce the likelihood that a reader might misinterpret such a paragraph to be a qualified opinion on the current-period basic financial statements, the paragraph should follow the opinion paragraph and should not be referred to in either the scope or opinion paragraphs of the auditor's report. Such a paragraph might read:

¹⁰ Reference to the date of the original report removes any implication that records, transactions, or events after that date have been examined. The auditor does not have a responsibility to investigate or inquire further into events that may have occurred during the period between the date of the original report on the complete financial statements and the date of the current report that refers to the summarized information.

¹¹ If the auditor's opinions on the financial statements were other than unqualified, the report should describe the nature of, and the reasons for, the opinion modifications. The auditor also should consider the effect that any modification of the original report on the financial statements might have on the current report that refers to the summarized information. For example, if the original auditor's report referred to another auditor or included an explanatory paragraph because of a material uncertainty, a going-concern matter, or an inconsistency in the application of accounting principles, the current report that refers to the summarized information should state that fact. However, no reference to the inconsistency is necessary if a change in accounting referred to in the original auditor's report on the complete financial statements does not affect the comparability of the information currently being presented.

¹² If prior-period partial or summarized information has been derived from financial statements that were audited by another auditor, the report should state that fact, and the auditor should not express an opinion on that information.

Explanatory paragraph: The financial statements include [*partial or summarized*] prior-year comparative information. Such information does not include [*all of the information required or sufficient detail to constitute*] a presentation in conformity with accounting principles generally accepted in the United States of America. Accordingly, such information should be read in conjunction with the government's financial statements for the year ended June 30, 20PY, from which such [*partial or summarized*] information was derived.

Year-to-Year Changes in Major Funds

14.39 As discussed in Chapter 2, major governmental and enterprise funds are determined in one of two ways. Some major funds are determined using quantitative criteria specified by GAAP. Other governmental and enterprise funds are presented as major based on management's judgment that the funds are particularly important to financial statement users. The standards for selecting major funds could result in different funds being reported as major each year. The quantitatively determined major funds may change due to changes in the relative financial information reported in various funds. The judgmentally determined major funds may change due to changing circumstances in the government. Such changes should not be considered a change in accounting principles affecting consistency, and thus no modification to the auditor's report is needed.

Major Fund Not Separately Displayed

14.40 As indicated in paragraph 14.22, it is a departure from GAAP if the fund financial statements do not report one or more governmental or enterprise funds as major in conformity with the quantitative criteria of GASB Statement No. 34. In that situation, the auditor should report adverse opinions on the "missing" major fund opinion units because of the omitted display. Because the funds will be displayed with nonmajor governmental or enterprise funds, the auditor also should modify the opinion on the remaining fund information opinion unit. The nature of the modification on the remaining fund information opinion unit (that is, whether it is a qualified or adverse opinion) should be based on the facts and circumstances surrounding the effect that including the funds has on the remaining fund information. (Chapter 10, "Equity and Financial Statement Reconciliations," discusses the auditor's consideration when a fund that is major in the current year's audit was not a major fund in the previous year's audit.)

Financial Statements That Include Only Part of the Reporting Entity¹³

Omission of Component Units

14.41 As discussed in Chapter 3, "The Financial Reporting Entity," GASB Statement No. 14, *The Financial Reporting Entity*, as amended, contains the standards for defining the governmental financial reporting entity and for identifying which legally separate entities are component units that should be included with another government (usually a primary government) in a financial reporting entity's financial statements. GASB Statement No. 14, paragraph 64, recognizes that there may be circumstances in which a primary government issues separate basic financial statements that exclude all component units (both blended and discretely presented), and requires that the limitations of the basic financial statements be clearly disclosed. Such separate

¹³ Individual fund and departmental, agency, and program financial statements are discussed in paragraphs 14.62 through 14.66.

basic financial statements for the primary government, in the absence of specific identification by the auditor, could be misinterpreted to be the complete basic financial statements of the financial reporting entity. Accordingly, the auditor's report on separate primary government basic financial statements, as illustrated in appendix A, Example 14A.10, should:

- Indicate that the financial statements are those of the primary government and not of the financial reporting entity.
- Define the term *primary government*.
- Indicate that the primary government's financial statements do not purport to, and do not, fairly present financial position, changes in financial position, and cash flows, where applicable, of the financial reporting entity in conformity with GAAP.
- Give opinions or disclaimers of opinion on the opinion units in the primary government's financial statements.

14.42 Governments sometimes present financial statements that omit the financial information of one or more (but not all) component units. The auditor's response depends on the materiality of the omission in relation to the relevant opinion unit(s). When an omitted component unit should have been presented as a blended component unit, the auditor considers whether the omitted component unit would have been presented as a major fund or instead as a part of the opinion unit that includes the aggregate remaining fund information and considers quantitative and qualitative factors in evaluating the materiality of the omission in the context of the relevant opinion unit. When the omitted component unit is fiduciary in nature, the auditor considers the omission within the context of the opinion unit that includes the aggregate remaining fund information. When the omitted component unit should have been discretely presented, the auditor considers the omission within the context of the opinion unit that includes the aggregate discretely presented component units.

Component Units Financial Statements

14.43 GASB Statement No. 14, paragraph 65, indicates that a component unit of a financial reporting entity may issue separate financial statements. Component units often issue separate financial statements, for example, to use in an official statement for the sale of component unit debt. GASB Statement No. 14 requires separately issued component unit financial statements to acknowledge that the entity is a component unit of another government and to disclose in the notes to the financial statements the primary government in whose financial reporting entity it is included and describe its relationship with the primary government. The auditors' report also should disclose that the entity is a component unit of a financial reporting entity. See the language used in the introductory paragraph of the illustrative auditor's report in appendix A, Example 14A.2.

Adoption of New Accounting Principles by Component Units

14.44 Component units may be required or elect to adopt accounting and financial reporting principles arising from new GASB standards earlier than their primary governments. SAS No. 58 (AU sec. 508.16–.18) explains the need for an explanatory paragraph when an entity has changed accounting principles that have a material effect on the comparability of the entity's financial statements. The reporting entity's auditor should consider the effect of a component unit's change in accounting principles on the auditor's report on the

reporting entity, based on the materiality of the change in accounting principles to the opinion unit in which the component unit is reported.

More-Detailed Materiality Levels

14.45 The terms of an audit engagement may require the auditor to set the scope of the audit and assess materiality at a more-detailed level than by the opinion units required for the basic financial statements (for example, at an individual fund- or fund-type level). Chapter 4 explains that a more-detailed audit scope supplements, rather than replaces, the scope of the audit on a government's basic financial statements.

14.46 In some situations, the financial statements that are subject to the more-detailed audit scope are reported separately in the government's basic financial statements. In that situation, the auditor should report on the more-detailed audit in terms of the presentation of the subject financial statements as part of the basic financial statements. For example, GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, as amended, requires the basic financial statements of a PERS with more than one defined benefit pension plan to display a statement of plan net assets and a statement of changes in plan net assets for each plan. The auditor engaged to audit the financial statements of each plan should report on that more-detailed audit scope by referring to the presentation in the basic financial statements. Appendix A, Example 14A.11, provides an illustrative auditor's report when the auditor has been engaged to audit the aggregate nonmajor governmental funds, the aggregate nonmajor enterprise funds, the internal service fund type, and each fiduciary fund type that comprise the basic financial statements' aggregate remaining fund information opinion unit.

14.47 In other situations, the financial statements that are subject to the more-detailed audit scope are not reported separately in the basic financial statements. In that situation, the auditor should report on the more-detailed audit in terms of the presentation of the subject financial statements outside of the basic financial statements as SI. This would involve, for example, the financial statements for a nonmajor enterprise fund that are aggregated in the basic financial statements with other nonmajor enterprise funds. Appendix A, Example 14A.12, provides an illustrative auditor's report when the auditor has been engaged to audit each fund in a government's combining and individual fund financial statements. See the further discussion in this regard in paragraph 14.51.

Required Supplementary Information and Supplementary Information

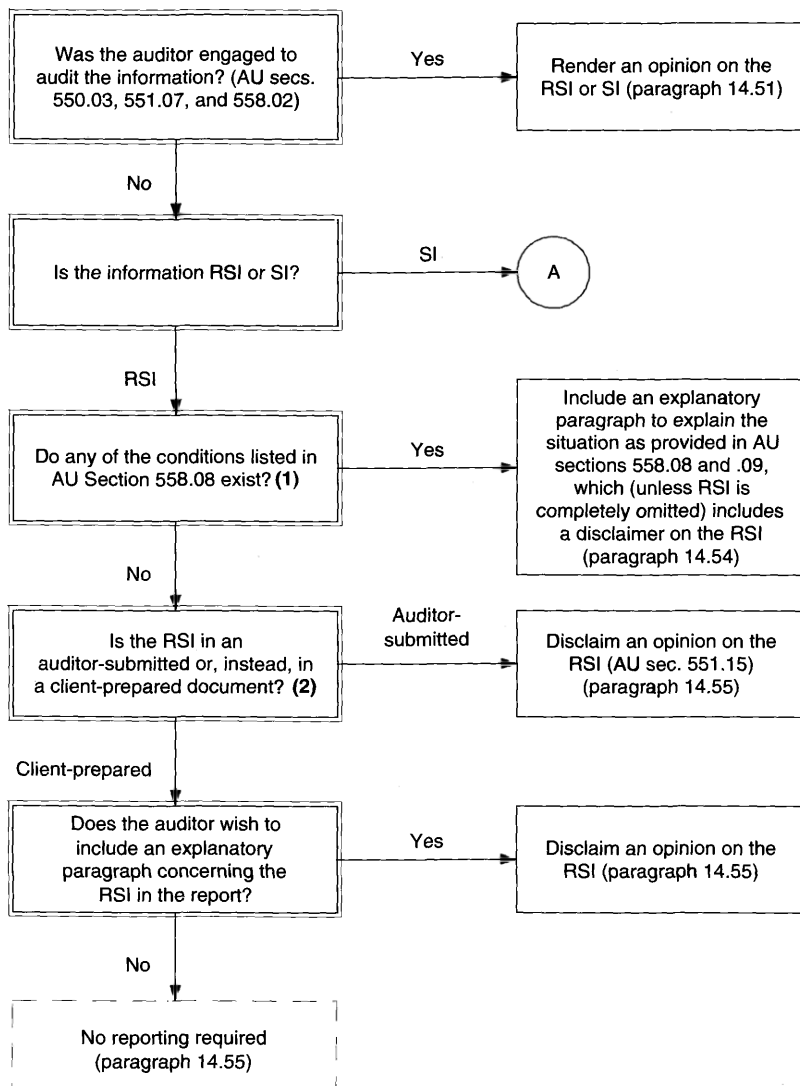
14.48 A government usually presents its basic financial statements in a document that includes various financial and statistical information presented outside the basic financial statements. RSI required by the GASB is MD&A and certain budgetary comparison, pension, risk financing, and capital asset condition assessment information, if applicable. (Chapter 2 discusses RSI requirements.) Governments may voluntarily provide supplementary information other than RSI, known as SI, such as introductory information (including a letter of transmittal), combining and individual nonmajor fund financial statements, schedules, and statistical tables, to supplement and expand upon the basic financial statements. A government's basic financial statements may be accompanied by both RSI and SI.

14.49 The manner in which the auditor reports on information that accompanies a government's basic financial statements depends on three factors: (a) audit scope, (b) whether the information is included in a client-prepared or an auditor-submitted document, and (c) whether the information is RSI or SI. With regard to factor *a*, the auditor may be engaged to audit and express an opinion on RSI or SI as discussed in paragraph 14.51. Paragraphs 14.52 through 14.60 discuss the effect on auditor reporting of the interaction of factors *b* and *c* if the audit scope does not include the information. Paragraph 14.61 discusses the effect on the principal auditor's report of another auditor's work on RSI and SI.

14.50 The flowchart in Exhibit 14.1 summarizes auditor reporting on RSI and SI as discussed in this section.

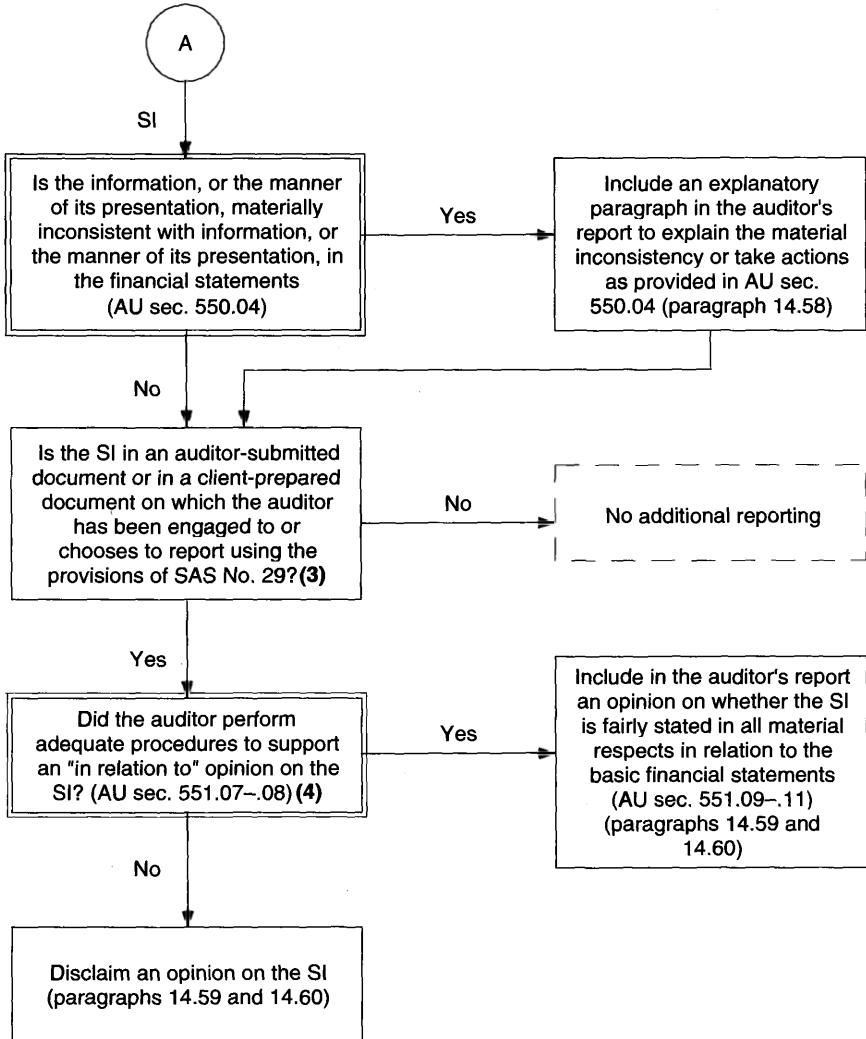
Exhibit 14.1

Reporting on RSI and SI



(1) The conditions listed in AU Section 558.08 are (a) the RSI is omitted, (b) the RSI measurement or presentation departs materially from prescribed guidelines, (c) the auditor is unable to complete the prescribed procedures, and (d) the auditor is unable to remove substantial doubts about whether the RSI conforms to prescribed guidelines. AU section 558.09 also requires an explanatory paragraph if the entity refers to the auditor's procedures on RSI without indicating that the auditor does not express an opinion.

(2) AICPA standards do not define when a document is auditor submitted or client prepared and leave that decision to professional judgment.



(3) SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551) requires the auditor to report on SI in an auditor-submitted document by including either an opinion on whether the SI is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion. In addition, a government may engage an auditor or the auditor may choose to report on SI in a client-prepared document using the provisions of SAS No. 29 (see paragraph 14.60).

(4) AU Section 551.06 indicates that an auditor may express an opinion on a portion of SI and disclaim an opinion on the remainder.

Audit Scope Includes Required Supplementary Information or Supplementary Information

14.51 The auditor may be engaged to render an opinion on whether either or both RSI and SI are fairly presented, in all material respects, in conformity with GAAP. Chapter 4 discusses auditor considerations in accepting such an engagement. When engaged to render an opinion on RSI or SI, the auditor establishes materiality for planning, performing, evaluating the results of, and reporting on the results of the audit depending on the terms of the engagement. Appendix A, Example 14A.12, illustrates an auditor's report when the engagement terms provide for the audit of each fund presented as SI in combining and individual nonmajor governmental, nonmajor enterprise, internal service, and fiduciary fund financial statements.

Required Supplementary Information

14.52 As discussed in Chapter 2, GASB standards specify that certain information be presented as RSI. Although RSI is not a part of the basic financial statements, auditors are required to perform certain limited procedures on RSI as discussed in Chapter 4. When designating information as RSI, the GASB has reached a conclusion that such information is not essential to the fair presentation of the basic financial statements. Therefore, the omission of RSI or the presentation of RSI in a manner that does not meet the standard established by the GASB will not affect the auditor's conclusion regarding the fair presentation of the basic financial statements. In establishing the prescribed guidelines for RSI, the GASB often requires notes to RSI and specifies the placement of RSI in relation to the basic financial statements. Those note and placement requirements are part of the prescribed guidelines. RSI and SI normally are presented separately from each other to assist user understanding of the nature of each. The auditor should consider whether RSI is sufficiently segregated from SI. Except in specific situations, professional standards do not address whether RSI should be labeled as unaudited and, thus, it may or may not be so labeled.¹⁴

14.53 For governments, only information required by the GASB and the Financial Accounting Standards Board (FASB), if applicable,¹⁵ can be considered RSI. All other information is considered SI even though law, regulation, or resource contributors may require that such information accompany the basic financial statements. Further, the nature of RSI does not permit governments to voluntarily expand the contents of RSI. For example, as discussed in Chapter 11, GASB Statement No. 34 requires a budgetary comparison schedule to be presented as RSI for the general fund and for each major special revenue fund that has a legally adopted annual budget. Budgetary comparison information for other funds, such as for nonmajor special revenue funds or for capital projects or debt service funds, may be presented as SI, but not as RSI.

¹⁴ See footnote 17. In addition, as discussed in Chapter 2, SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558.10), discusses alternative placement of RSI provided it is clearly marked as unaudited. However, that alternative placement is not available for GASB-required supplementary information given the GASB's specific requirements for placement, and the requirement for such labeling in that situation also is not applicable.

¹⁵ At present, the Financial Accounting Standards Board (FASB) has no RSI requirements that affect governmental entities. Future FASB-established RSI, if any, would be applicable to only those enterprise funds and business-type activities that apply post-November, 30, 1989 FASB standards that do not conflict with or contradict GASB standards.

14.54 SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558.08), and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 551.15), require auditor reporting on RSI if (a) the information that the FASB or GASB requires to be presented in the circumstances is omitted; (b) the auditor has concluded that the measurement or presentation of the information departs materially from prescribed guidelines; (c) the auditor is unable to complete the prescribed procedures; or (d) the auditor is unable to remove substantial doubts about whether the information conforms to prescribed guidelines. SAS No. 52 (AU sec. 558.08) provides example language for explanatory paragraphs that, except for an explanatory paragraph because all RSI is omitted, includes a disclaimer on the information. The language for such explanatory paragraphs is not affected by the requirement to express opinions on governmental financial statements based on opinion units. An example of an explanatory paragraph if a portion of required budgetary comparison information is omitted¹⁶ follows:

The management's discussion and analysis on pages XX through XX and the budgetary comparison information on pages XX and XX are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it. The City of Example, Any State, has not presented the budgetary comparison information for the *[indicate the funds for which information is omitted]* that the Governmental Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

14.55 When an auditor-submitted document contains RSI and the conditions listed in paragraph 14.54 do not exist, the auditor is required to disclaim an opinion on the information.¹⁷ When a client-prepared document contains RSI and the conditions listed in paragraph 14.54 do not exist, the auditor has no reporting requirement but may voluntarily disclaim an opinion on the RSI.¹⁸ Appendix A, Example 14A.1, provides example language for the disclaimer. The language for that disclaimer is not affected by the requirement to report on opinion units.

14.56 These situations regarding RSI require auditor consideration:

- In certain circumstances, a budget is not adopted for the general or a major special revenue fund because it is not legally required and,

¹⁶ If all of the required budgetary comparison information is omitted or if only part of the required budgetary comparison information is presented as RSI, the omission of required budgetary comparison information is an omission of RSI. If, however, the government chooses to present required budgetary comparison information as a basic financial statement and presents only part of the required information, the omission constitutes a departure from GAAP in the basic financial statements that the auditor should consider in evaluating his or her opinions on the opinion units for which budgetary presentations are required but not made.

¹⁷ When the auditor disclaims an opinion on all or part of the information accompanying the basic financial statement in auditor-submitted documents, SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, (AICPA, *Professional Standards*, vol. 1, AU sec. 551.13), requires such information to either be marked as unaudited or to include a reference to the auditor's disclaimer of opinion.

¹⁸ Some auditors voluntarily disclaim an opinion on RSI in client-prepared documents to inform the report user of the extent of auditor responsibility for the information.

therefore, presentation of budgetary comparison information is not required. Although that situation should not result in the auditor reporting that RSI has been omitted, it should be disclosed in the notes to RSI¹⁹ to explain why what might appear to be required information is not part of the presentation.

- If a government does not present RSI relating to infrastructure assets accounted for using the modified approach, that omission does not affect the government's ability to apply the modified approach to infrastructure assets in its basic financial statements. However, the entity should meet the conditions required to use the modified approach, as discussed in Chapter 7, and the auditor should include a paragraph in the report about the omitted RSI.
- If a government is presenting comparative prior-year financial statements, the GASB staff document *Guide to Implementation of GASB Statement No. 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers* (GASB 34 Q&A), item 8, states that MD&A is required to address both years presented in the comparative financial statements. The comparative MD&A would include comparative condensed financial information and related analysis for both years, but completely separate MD&As are not required.

Supplementary Information

14.57 GASB standards require or permit certain information to accompany the basic financial statements but do not specifically identify the information as RSI. For example, a CAFR is required to include a letter of transmittal and other introductory information and statistical tables. Even though GASB standards specify that such information should or may be presented, that information is SI because it is not identified as RSI. In addition, preparers may voluntarily provide other SI.

14.58 As discussed in Chapter 4, SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550.04), requires the auditor to read SI and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the basic financial statements. That requirement applies whether the document that contains the SI is auditor submitted or client prepared. If the auditor concludes that there is a material inconsistency in the SI, the auditor should determine whether the financial statements, the auditor's report, or both require revision. If the auditor concludes that the financial statements or the auditor's report do not require revision, he or she should request the client to revise the SI or take other steps as indicated in SAS No. 8 (AU sec. 550.04).

14.59 Further, if the SI is included in an auditor-submitted document, SAS No. 29 requires the auditor to report on whether the SI is stated fairly in all material respects in relation to the basic financial statements taken as a whole or disclaim such an opinion. SAS No. 29 (AU sec. 551.06) indicates that an auditor may express an opinion on a portion of SI and disclaim an opinion on the remainder.²⁰ The auditor can only express an opinion on SI that

¹⁹ If the government chooses to present its required budgetary comparison information in the basic financial statements, this disclosure should be made in the notes to the financial statements.

²⁰ See footnote 17.

is financially oriented. Chapter 4 discusses procedures needed to be able to render an “in relation to” opinion. SAS No. 29 (AU sec. 551.12–.14) provides example language for the auditor’s report, which should be adjusted for the concept of providing opinions on each opinion unit in the basic financial statements but still provide an opinion on the SI in relation to the basic financial statements taken as a whole. Illustrative auditor reporting on SI is shown in Appendix A, Example 14A.1.

14.60 Although the scope of SAS No. 29 does not include client-prepared documents, auditors often are engaged to report on some or all of the SI that accompanies financial statements in client-prepared documents using that SAS. If so engaged, auditors should include either an opinion on whether that SI is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, as discussed in paragraph 14.59.²¹ If the auditor is not engaged to report on SI, the auditor may choose to issue a disclaimer of opinion on the SI²² or ask the government to label the SI as unaudited.

Effect of Another Auditor

14.61 Governmental financial statements often are accompanied by RSI or SI relating to a portion of the reporting entity, usually component units, whose financial statements were audited by another auditor. In those situations, the principal auditor should follow GAAS in deciding whether to perform required procedures on that information or, instead, to rely on the work of the other auditor. If the principal auditor performs the required procedures, the discussion earlier in this section applies. If the principal auditor decides instead to rely on the work of the other auditor, the auditor needs to determine if he or she can rely on and whether to refer to the work of the auditor, and then decide how to report that reference, as provided in AU Section 543, “Part of Audit Performed by Other Independent Auditors, SAS No. 1.” (AICPA, *Professional Standards*, vol. 1, AU sec. 543). Paragraphs that provide an unqualified opinion on SI based in part on the report of another auditor and that refer to the work of other auditors on RSI are illustrated in appendix A, Example 14A.9.

Other Financial Presentations

Individual Fund Financial Statements

14.62 Many entities issue separate GAAP-basis financial statements for one or more individual funds, for example, to use in an official statement for the sale of enterprise fund revenue bonds. Financial statements for one or more individual funds are intended to represent the specific fund(s) and not the overall government, and the financial statements normally follow the requirements established for fund financial statements and do not include government-wide financial statements. In developing an opinion on financial

²¹ Often, the terms of an engagement require the auditor to report only on supplementary information other than RSI, known as SI, that is financially oriented; in those situations, the auditor can express an opinion on that SI. However, sometimes the terms of an engagement require the auditor to report on all SI, including letters of transmittal and other introductory information and statistical data, which typically include information that is not financially oriented. For SI that is not financially oriented, the auditor cannot express an opinion and should disclaim an opinion.

²² Some auditors voluntarily disclaim an opinion on SI in client-prepared documents to inform the report user of the extent of auditor responsibility for the information.

statements for one or more individual funds, the auditor considers GAAP as defined for the fund financial statements. Because the presentations are equivalent to the presentation of major fund financial statements, the auditor should plan, perform, evaluate the results of, and report on the audit based on each fund as a separate opinion unit.

14.63 The introductory and opinion paragraphs of the auditor's report on an audit of fund financial statements should indicate the specific fund(s). The report also should include an explanatory paragraph after the scope paragraph indicating that the financial statements do not purport to, and do not, present the government's financial position, changes in financial position, and cash flows, where applicable. See the illustrative auditor's report in appendix A, Example 14A.13.

14.64 Auditors may be asked to issue a separate report on individual fund financial statements that are covered by the audit of the government's audited basic financial statements. Because of the focus of an audit of a government's basic financial statements on opinion units, audit procedures on the basic financial statements of an overall government may or may not be adequate to support an opinion on an individual fund's financial statements. For example, those audit procedures might not be adequate if the fund is a nonmajor fund in the government's basic financial statements and thus part of the aggregate remaining fund information opinion unit. In that situation, the auditor may need to perform additional audit procedures to support the opinion on the individual fund. However, if the fund is a major fund in the government's basic financial statements, it is likely that additional procedures will not be needed to support the auditor's opinion on the individual fund financial statements.

14.65 When financial statements present only individual fund(s), the auditor should evaluate the extent to which the resulting presentation may be misleading to financial statement users who might misunderstand that the financial statements are meant to represent the overall government. For example, if a government presents a complete set of fund financial statements, that results in a misleading presentation and, as discussed in paragraph 14.10, the auditor should express an adverse opinion on the financial statements taken as a whole. Financial statements that include more than one fund are more likely to result in a misleading presentation. The point at which financial statements for more than one fund move from being an acceptable presentation of individual fund financial information to an incomplete presentation of the overall government is a matter of professional judgment considering in part what the financial statements purport to represent.

Departmental, Agency, and Program Financial Statements

14.66 Many entities, particularly state governments, issue separate GAAP-basis financial statements for the government's departments, agencies, or programs.^{23, 24} (This paragraph uses the term *department* to refer to departments, agencies, and programs.) The auditor should plan, perform, evaluate

²³ When an organizational unit is coterminous with a single fund, it is appropriate to issue a fund financial statement, as discussed in paragraphs 14.62 through 14.65, rather than a departmental financial statement.

²⁴ Some reasons why separate departmental audits may be conducted include: there may be legal or contractual provisions for certain departments to be separately audited; the department may be a separate accountability center; the separate audits may be part of a series of audits for purposes of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*; or separate audits may be an efficient way to plan and execute the work for the audit of the overall government's financial statements.

the results of, and report on the audit based on the involved opinion units. The introductory and opinion paragraphs of the auditor's report on an audit of departmental financial statements should indicate the department. The report also should include an explanatory paragraph after the scope paragraph that indicates the financial statements do not purport to, and do not, present the government's financial position, changes in financial position, and cash flows, where applicable. See the illustrative auditor's report in appendix A, Example 14A.14.

Special-Purpose Regulatory Presentations

14.67 Law or regulation may require governments to prepare and file with a regulatory agency financial statements that do not constitute a complete presentation of all the financial statements required by GASB Statement No. 34, but that otherwise are prepared in conformity with GAAP.²⁵ For example, state regulations may require that a county prepare and file with a state agency fund financial statements for each separately elected county official, and specify that those financial statements be prepared using GAAP measurements, presentations, and disclosures. In those situations, the auditor's report should follow the guidance in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.22–.26). The auditor should make materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audits of such special-purpose presentations in a manner consistent with the requirements of the presentation and with the concept of opinion units as discussed in Chapters 4 and 13 and elsewhere in this chapter. In all situations, the wording of the introductory and opinion paragraphs of the auditor's report should be sufficiently clear to inform the reader of the opinion unit(s) considered by the auditor. The form of the auditor's report should follow the provisions of SAS No. 62 (AU sec. 623.25). Consequently, the report should include a separate paragraph at the end stating that the report is intended solely for the information and use of those within the entity and the regulatory agency with which the report is being filed, and is not intended to be and should not be used by anyone other than these specified parties. That restricted-use paragraph is appropriate in all cases for such governmental special-purpose financial presentations.²⁶

Summary Financial Information

14.68 Some governments issue *popular reports*, directed primarily to citizens, that contain highly condensed summary financial information with accompanying notes to those financial statements. Paragraph 175 of National Council on Government Accounting (NCGA) Statement 1, *Governmental*

²⁵ Other paragraphs in this chapter discuss the auditor's reports on financial statements for the primary government only (paragraph 14.41), an individual component unit (paragraph 14.43), individual funds (paragraphs 14.62 through 14.65), and departments, agencies, and programs (paragraph 14.66). The provisions of those paragraphs apply to those financial presentations, even if those presentations are required by law or regulation, unless the law, regulation, or terms of the audit engagement require the auditor to issue a report using the provisions of paragraphs 22 through 26 of SAS No. 62 (AU sec. 623.22–.26).

²⁶ The provision in SAS No. 62 (AU sec. 623.25f) directing when a restricted-use paragraph is not appropriate is not applicable to auditors' reports on governmental special-purpose regulatory presentations. A restricted-use paragraph always is appropriate for such governmental presentations because those presentations are not equivalent to filings with the Securities and Exchange Commission of information to be included in a prospectus, the situation for which that exception was intended.

Accounting and Financial Reporting Principles, as amended, requires that condensed summary financial statements supplement, rather than replace, the CAFR and the separately issued basic financial statements. That standard also requires that the data in those summary financial statements be reconcilable with the government's basic financial statements and refer the reader to the government's CAFR or basic financial statements.

14.69 The following paragraphs provide reporting guidance when an auditor of the basic financial statements is engaged to report on summary financial information issued by a government in a document that refers to, but does not include, the basic financial statements. The auditor may report on summary financial information only if the auditor has rendered an opinion on the government's basic financial statements and the auditor has not rendered a disclaimer of or adverse opinion on one of the opinion units from which the summary financial information was derived or on the basic financial statements taken as a whole. Where more than one auditor has been involved in rendering an opinion on the basic financial statements, only the principal auditor should render the opinion on the summary financial information.

14.70 Summary financial information often differs in format and content from basic financial statements prepared in conformity with GAAP. Some governments include only their government-wide financial statements or only their fund financial statements (and related note disclosures) in their popular reports.²⁷ Other governments include either or both summarized government-wide and fund financial statements (and related note disclosures). That financial information may differ from GAAP in areas of summarization, aggregation, eliminations, inclusion of component units, or disclosure.

14.71 Governments should exercise discretion in preparing summary financial information for popular reports. At a minimum, the summary financial information should (a) be informative of matters that may affect its use, understanding, and interpretation (for example, the financial statements should be accompanied by notes that describe or should otherwise consider significant subsequent events, significant contingencies, or restrictions on resources), (b) be prepared on the same measurement focus and basis of accounting as the relevant portion of the basic financial statements,²⁸ (c) be classified, summarized, and presented in a reasonable manner, and (d) reflect the underlying transactions and events in a manner that presents the summarized data within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in summary financial information. The summary financial information should be clearly marked as such, and not as combined, consolidated, or condensed financial information, which users may relate to GAAP.

14.72 The auditor's report on summary financial information should be based on the auditor's judgment as to whether the summary financial information, including the related notes, are fairly stated in all material respects in relation to the portion of the basic financial statements from which it has been

²⁷ An auditor should apply the guidance in this section only when the summary financial information supplements, rather than replaces, the Comprehensive Annual Financial Report (CAFR) or the separately issued basic financial statements and refers the reader to the government's CAFR or basic financial statements. If the government does not issue a CAFR or basic financial statements and presents only government-wide financial statements or only fund financial statements, the auditor should apply the guidance in paragraphs 14.10 and 14.25.

²⁸ For example, if the summary financial information is related to the governmental funds, a current financial resources measurement focus and modified accrual basis of accounting should be used.

derived. In making that judgment, the auditor should consider the four minimum conditions listed in paragraph 14.71. The auditor also should consider whether the summary financial information is fairly presented in accordance with the method of aggregation described in the notes to the summary financial information. Further, the auditor should consider whether the notes to the summary financial information disclose how the method of aggregation differs from the accounting policies used in preparing the basic financial statements, either through a numerical reconciliation or a narrative explanation and whether the notes refer the reader to the government's CAFR or basic financial statements.

14.73 Appendix A, Example 14A.15, illustrates the auditor's report when the auditor concludes that summary financial information is fairly stated in all material respects in relation to the portion of the basic financial statements from which it has been derived. The report should include:

- a. A statement that the auditor has audited the financial statements of the opinion units of the entity, which comprise the entity's basic financial statements, and a reference to the auditor's report on those basic financial statements, including the date of that report and a description of any modification of the standard report on the basic financial statements
- b. A statement that the accompanying summary financial information is not a presentation in conformity with GAAP, with a reference to the note to the summary financial information describing the method of aggregation
- c. An opinion as to whether the information presented in the summary financial information is fairly stated in all material respects in relation to the portion of the basic financial statements from which it has been derived (The issuance of a qualified opinion on one or more opinion units in the basic financial statements does not preclude the auditor from issuing a report on the summary financial information. Note, however, that an auditor is prohibited from issuing a report on summary financial information if the auditor rendered a disclaimer of or adverse opinion on one of the opinion units from which the summary financial information was derived or on the basic financial statements taken as a whole.)
- d. The date of the audit report on the summary financial information, which, unless significant subsequent events have occurred, should be the same as the date of the audit report rendered on the basic financial statements from which it was derived (If a material event occurs subsequent to the date of the audit report on the basic financial statements, the audit report on the summary financial information should be dual dated for the subsequent event disclosed in the notes to the summary financial information.)

14.74 If a government issues summary financial information in a manner inconsistent with the guidance provided in paragraph 14.71 (for example, because the measurement focus and basis of accounting differs from that of the portion of the basic financial statements from which it has been derived²⁹), the

²⁹ A different measurement focus and basis of accounting would result, for example, from changing from a modified accrual basis of accounting to a cash basis or recording depreciation on general capital assets in an activity statement that is derived from the governmental fund statement of revenues, expenses, and changes in fund balances.

auditor should express an adverse opinion on the summary financial information. In expressing an adverse opinion, the report should describe (a) all of the substantive reasons for the adverse opinion and (b) the principal effects of the subject matter of the adverse opinion on the financial position, changes in financial position, or cash flows, where applicable. If the effects are not reasonably determinable, the report should so state.

14.75 When SI accompanies summary financial information, the auditor's responsibility for performing procedures and reporting on that information is the same as described in Chapter 4 and earlier in this chapter. Because summary financial information is not presented in conformity with GAAP, GASB requirements for RSI do not apply to those presentations. Any information that accompanies the summary financial information is considered SI.

Transition to GASB Statement No. 34

14.76 The adoption of GASB Statement No. 34 constitutes a change in accounting principles that, unless immaterial, will require the auditor's report to include an explanatory paragraph regarding consistency. Such a paragraph could read:

As described in Note X, the City has implemented a new financial reporting model, as required by the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as of June 30, 20X1.

14.77 As discussed in the transition section of Chapter 2, a component unit is required to implement GASB Statement No. 34 no later than the same year as its primary government, even if that is earlier than the component unit's established implementation phase and even if its primary government implements the standard early. In certain situations, a component unit is required to implement GASB Statement No. 34 earlier than its primary government is required to implement the standard. If a component unit does not implement GASB Statement No. 34 when required, that constitutes a departure from GAAP both in the component unit's separate financial statements and in the reporting entity's financial statements. The auditor should consider modifying the opinion on the financial statements depending on the magnitude and pervasiveness of the departure to the involved opinion units.

Appendix 14A—Illustrative Auditor's Reports

A.1 This appendix illustrates auditor's reports in specific situations discussed in this chapter. Auditors should modify the illustrative reports as needed in different situations, using selected elements of the illustrative reports where appropriate. The following list describes conditions that may make modifications necessary. Other conditions that may make modifications necessary are described in the footnotes to the illustrative reports.

- The illustrative auditor's reports cover a single year. Paragraphs 14.33 through 14.38 discuss modifications to the auditor's report on the basic financial statements when those financial statements include information from a prior period.
- The auditor's report may need to separately name each individual major fund rather than refer to "each major fund." See paragraph 14.15.
- The introductory and opinion paragraphs should list only the opinion units presented in the financial statements. As discussed in paragraph 14.04, under certain circumstances, the auditor may choose to combine the two aggregate opinion units—the one for the aggregate discretely presented component units and the one for the aggregate remaining fund information—as a single opinion unit. If that is done, the terms *aggregate discretely presented component units* and *aggregate remaining fund information* should not be used in the auditor's report, for example, as shown in Example 14A.1. Instead, the auditor's report should use the term *aggregate discretely presented component unit and remaining fund information*.
- If the audit is conducted in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States, the scope paragraph should be modified and a separate paragraph added after the opinion paragraph to refer to the *Government Auditing Standards* reports. See the illustrative auditor's report 1 in Appendix D of Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (Appendix D of this Guide).
- If a government presents required budgetary comparison information as basic financial statements instead of as RSI, the opinion paragraph should be modified to refer to the budgetary comparison in the manner shown in footnote 31.
- The opinion paragraph should refer to cash flows only if the financial statements present one or more statements of cash flows. If only some opinion units present statements of cash flows, the opinion paragraph should refer to "cash flows, where applicable."
- Because of the GASB requirement that financial statements be accompanied by MD&A, most governmental financial statements are required to present RSI. A government's financial statements also may be accompanied by SI. Paragraphs 14.52 through 14.61 discuss auditor reporting on RSI and SI. When reporting on SI, the auditor should consider the effect of any modifications in the report on the basic financial statements. Guidance for such modifications are in paragraphs

10 and 14 of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551.10 and .14). The SI paragraph also should be modified for a qualified or adverse opinion on SI. Examples 14A.1 and 14A.9 illustrate auditor reporting on RSI and SI and assume that the auditor is required to or chooses to report on RSI and SI.

- **Transition Note:** The adoption of GASB Statement No. 34 constitutes a change in accounting principles that, unless immaterial, will require the auditor's report to include an explanatory paragraph regarding consistency. An example is shown in paragraph 14.77.

A.2 The illustrative reports in this appendix are:

- Example 14A.1: Unqualified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Supplementary Information
- Example 14A.2: Unqualified Opinion on the Basic Financial Statements of a Special-Purpose Government That Has a Single Opinion Unit
- Example 14A.3: Unqualified Opinions on the Basic Financial Statements of a Special-Purpose Government That Has One Opinion Unit for the Primary Government and Another Opinion Unit for its Aggregate Discretely Presented Component Units
- Example 14A.4: Report on Basic Financial Statements That Includes a Qualified Opinion Because One (But Not All) Discretely Presented Component Units are Not Audited
- Example 14A.5: Report on Basic Financial Statements That Includes a Qualified Opinion on Major Governmental Funds Because of a GAAP Departure
- Example 14A.6: Report on Basic Financial Statements That Includes an Adverse Opinion on the Governmental Activities Because Certain General Infrastructure Assets are Omitted
- Example 14A.7: Report on Basic Financial Statements That Includes an Adverse Opinion on the Governmental Activities Because Compensated Absences are Omitted
- Example 14A.8: Report on Basic Financial Statements That Presents an Adverse Opinion on the Financial Statements Taken as a Whole Because the Government-wide Financial Statements are Omitted
- Example 14A.9: Unqualified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Supplementary Information, With Reference to an Audit by Another Auditor
- Example 14A.10: Unqualified Opinions on the Basic Financial Statements of a Primary Government That Omits the Financial Data of Each Component Unit
- Example 14A.11: Unqualified Opinions on Basic Financial Statements and on Additional Detail Presented in the Basic Financial Statements

- Example 14A.12:** Unqualified Opinions on Basic Financial Statements and on Combining and Individual Fund Financial Statements Presented as Supplementary Information
- Example 14A.13:** Unqualified Opinion on General Fund Financial Statements
- Example 14A.14:** Unqualified Opinions on Departmental Financial Statements
- Example 14A.15:** Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance in Paragraph 14.71

Example 14A.1: Unqualified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Supplementary Information³⁰

(Paragraphs 14.12 through 14.15 and 14.52 through 14.60)

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.³¹

The [identify accompanying required supplementary information, such as management's discussion and analysis and budgetary comparison information] on pages XX through XX and XX through XX are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The [identify accompanying supplementary information, such as

³⁰ Paragraph A.1 describes conditions that may make modifications to this report necessary.

³¹ If a government presents required budgetary comparison information as basic financial statements instead of as RSI, the opinion paragraph would be replaced with the following: "In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the [indicate the major governmental funds involved] for the year then ended in conformity with accounting principles generally accepted in the United States of America."

the introductory section, combining and individual nonmajor fund financial statements, and statistical tables] are presented for purposes of additional analysis and are not a required part of the basic financial statements. The *[identify relevant supplementary information, such as the combining and individual nonmajor fund financial statements]* have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The *[identify relevant supplementary information, such as the introductory section and statistical tables]* have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

[Signature]

[Date]

**Example 14A.2: Unqualified Opinion on the
Basic Financial Statements of a Special-Purpose
Government That Has a Single Opinion Unit³²**

(Paragraphs 14.16 and 14.43)

Independent Auditor's Report

We have audited the accompanying basic financial statements of the Example Component Unit (ECU), a component unit of the City of Example, Any State,³³ as of and for the year ended June 30, 20X1, as listed in the table of contents. These financial statements are the responsibility of the ECU management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the ECU as of June 30, 20X1, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.³⁴

[Signature]

[Date]

³² Paragraph A.1 describes conditions that may make modifications to this report necessary.

³³ As discussed in paragraph 14.43, the auditors' report should disclose that an entity is a component unit of a financial reporting entity. If the special-purpose government is not a component unit of another government, this reference to being a component unit should be removed.

³⁴ In the opinion paragraph, the terms *financial position* and *changes in financial position* could be replaced with terms that would be more descriptive in the circumstances. For example, in a report on a public employee retirement system (PERS), the terms *plan net assets* and *changes in plan net assets* could be used.

Example 14A.3: Unqualified Opinions on the Basic Financial Statements of a Special-Purpose Government That Has One Opinion Unit for the Primary Government and Another Opinion Unit for its Aggregate Discretely Presented Component Units³⁵

(Paragraph 14.16)

Independent Auditor's Report

We have audited the accompanying basic financial statements of the Example District, Any State, and its aggregate discretely presented component units as of and for the year ended June 30, 20X1, as shown on pages XX through XX. These financial statements are the responsibility of the District's management. Our responsibility is to express opinions on these financial statements based on our audit.

[Same second paragraph as in Example 14A.1]

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the District and of its aggregate discretely presented component units as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

³⁵ Paragraph A.1 describes conditions that may make modifications to this report necessary.

**Example 14A.4: Report on Basic Financial Statements
That Includes a Qualified Opinion Because One (But Not All)
Discretely Presented Component Units are Not Audited^{36, 37}**

(Paragraph 14.19)

Independent Auditor's Report

[Same first paragraph as in Example 14A.1]

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

The financial statements of Example Component Unit (ECU) have not been audited, and we were not engaged to audit the ECU financial statements as part of our audit of the City's basic financial statements. ECU's financial activities are included in the City's basic financial statements as a discretely presented component unit and represent XX percent and XX percent of the assets and revenues, respectively, of the City's aggregate discretely presented component units.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had ECU's financial statements been audited, the financial statements referred to above present fairly, in all material respects, the financial position of the aggregate discretely presented component units for City of Example, Any State, as of June 30, 20X1, and the changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information for City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

³⁶ Paragraph A.1 describes conditions that may make modifications to this report necessary.

³⁷ This example assumes that the auditor has concluded that the single unaudited component unit warrants a qualified opinion. Another auditor could make a different professional judgment. If the auditor were to conclude that a disclaimer of opinion on the aggregate discretely presented component units (but not on the financial statements taken as a whole) is appropriate, the first opinion paragraph would read as follows: "Because ECU's financial statements have not been audited, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements of the aggregate discretely presented component units of the City of Example, Any State, as of and for the year ended June 30, 20X1." Paragraphs 14.10, 14.20, and 14.21 discuss disclaimers of opinion.

**Example 14A.5: Report on Basic Financial
Statements That Includes a Qualified Opinion on Major
Governmental Funds Because of a GAAP Departure^{38, 39}**

(Paragraph 14.23)

Independent Auditor's Report

[Same first and second paragraphs as in Example 14A.1]

Management has not adopted a methodology for reviewing the collectibility of taxes receivable in the *[indicate the affected major governmental funds]* and, accordingly, has not considered the need to provide an allowance for uncollectible amounts. Accounting principles generally accepted in the United States of America require that an adequate allowance be provided for uncollectible receivables, which would decrease the assets and change the revenues in the *[indicate the affected funds]*. The amount by which this departure would affect the assets and revenues of the *[indicate the affected funds]* is not reasonably determinable.^{40, 41}

In our opinion, except for the effects, if any, of not providing an adequate allowance for uncollectible taxes receivable for the *[indicate the affected major governmental funds]* as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the respective financial position of the *[indicate the affected major governmental funds]* of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, *[indicate the major funds not affected by the qualification]*, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

³⁸ Paragraph A.1 describes conditions that may make modifications to this report necessary.

³⁹ Depending on the nature and magnitude of the GAAP departure, it is possible that the auditor's opinion on the governmental activities also would be qualified. Further, the same GAAP departure in the nonmajor governmental funds could affect the auditor's opinion on the aggregate remaining fund information. This example assumes that the auditor has concluded that the GAAP departure is not material to the governmental activities opinion unit or to the aggregate remaining fund information opinion unit. Another auditor could make a different professional judgment. (See paragraphs 14.07 and 14.08.)

⁴⁰ Based on the guidance in SAS No. 58, *Reports on Audited Financial Statements*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 508.38), the explanatory paragraph should disclose the principal effects of the subject matter of the qualification on the financial position, changes in financial position, and cash flows, where applicable, for the opinion unit, if practicable. AU sec. 508.38 describes when obtaining that information is practicable. If the effects are not reasonably determinable, the report should so state, as shown in this example.

⁴¹ If a government presents budgetary comparison information as basic financial statements instead of as RSI, the explanatory paragraph also should explain the effect, if any, of the GAAP departure on the budgetary comparison information. This example assumes that the government budgets on a cash basis, and thus the GAAP departure would not affect the budgetary comparison information if it were presented as a basic financial statement.

Example 14A.6: Report on Basic Financial Statements That Includes an Adverse Opinion on the Governmental Activities Because Certain General Infrastructure Assets are Omitted^{42, 43}

(Paragraph 14.24)

Independent Auditor's Report

[Same first and second paragraphs as in Example 14A.1]

As discussed in Note X to the financial statements, management has not recorded certain general infrastructure assets in governmental activities and, accordingly, has not recorded depreciation expense on those assets. Accounting principles generally accepted in the United States of America require that those general infrastructure assets be capitalized and depreciated, which would increase the assets and expenses of the governmental activities. The amount by which this departure would affect the assets and expenses of the governmental activities is not reasonably determinable.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the governmental activities of the City of Example, Any State, as of June 30, 20X1, and the changes in financial position thereof for the year then ended.

In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

⁴² Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁴³ As discussed in paragraph 14.24, an adverse opinion usually would be appropriate if a general-purpose government omits general infrastructure assets. Further, depending on the nature and magnitude of the facts and circumstances leading to an adverse opinion on one or more opinion units, it is possible that the auditor would conclude that it is appropriate to issue an adverse opinion on the financial statements taken as a whole. (See paragraphs 14.10 and 14.25.) This example assumes that the auditor has concluded that the GAAP departure warrants an adverse opinion on the governmental activities, but not on the financial statements taken as a whole. Another auditor could make a different professional judgment and issue an adverse opinion on the financial statements taken as a whole, and thus use the opinion paragraph in Example 14A.8.

**Example 14A.7: Report on Basic Financial Statements
That Includes an Adverse Opinion on the Governmental
Activities Because Compensated Absences are Omitted^{44, 45}**

(Paragraphs 14.07, 14.08, and 14.24)

Independent Auditor's Report

[Same first and second paragraphs as in Example 14A.1]

As discussed in Note X to the financial statements, management has not recorded a liability for compensated absences in governmental activities and, accordingly, has not recorded an expense for the current period change in that liability. Accounting principles generally accepted in the United States of America require that compensated absences attributable to employee services already rendered and that are not contingent on a specific event that is outside the control of the employer and employee be accrued as liabilities and expenses as employees earn the rights to the benefits, which would increase the liabilities and change the expenses of the governmental activities. The amount by which this departure would affect the liabilities and expenses of the governmental activities is not reasonably determinable.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the governmental activities of the City of Example, Any State, as of June 30, 20X1, and the changes in financial position thereof for the year then ended.

In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

⁴⁴ Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁴⁵ Depending on the nature and magnitude of the GAAP departure, it is possible that the auditor would issue a qualified opinion rather than an adverse opinion. Further, depending on the nature and magnitude of the facts and circumstances leading to an adverse opinion on one or more opinion units, it is possible that the auditor would conclude that it is appropriate to issue an adverse opinion on the financial statements taken as a whole. (See paragraphs 14.10 and 14.25.) This example assumes that the auditor has concluded that the GAAP departure warrants an adverse opinion on the governmental activities, but not on the financial statements taken as a whole. Another auditor could make a different professional judgment and either issue a qualified opinion (see Example 14A.5) or issue an adverse opinion on the financial statements taken as a whole, using the opinion paragraph in Example 14A.8.

Example 14A.8: Report on Basic Financial Statements That Presents an Adverse Opinion on the Financial Statements Taken as a Whole Because the Government-wide Financial Statements are Omitted⁴⁶

(Paragraphs 14.10 and 14.25)

Independent Auditor's Report

We have audited the accompanying financial statements of each major fund and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, as shown on pages XX through XX, which collectively comprise a portion of the City's basic financial statements required by accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

[Same second paragraph as in Example 14A.1]

Management has not presented government-wide financial statements to display the financial position and changes in financial position of its governmental activities, business-type activities, and discretely presented component units. Accounting principles generally accepted in the United States of America require the presentation of government-wide financial statements. The amounts that would be reported in government-wide financial statements for the City's governmental activities, business-type activities, and discretely presented component units are not reasonably determinable.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the City of Example, Any State, as of June 30, 20X1, or the changes in its financial position or its cash flows, where applicable, for the year then ended.

[Signature]

[Date]

⁴⁶ Paragraph A.1 describes conditions that may make modifications to this report necessary.

Example 14A.9: Unqualified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Supplementary Information, With Reference to an Audit by Another Auditor⁴⁷

(Paragraphs 14.26 and 14.27 and 14.52 through 14.61)

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of *[identify organization, function, or activity]*, which represent XX percent and XX percent, respectively, of the assets and revenues of the *[identify opinion unit(s)]*.⁴⁸ Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for *[identify organization, function, or activity]*, is based on the report of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The *[identify accompanying required supplementary information]* on pages XX through XX are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The *[identify accompanying supplementary information]*

⁴⁷ Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁴⁸ If an entire opinion unit was audited by other auditor(s), this sentence would change to: "We did not audit the financial statements of the *[identify opinion unit(s)]*."

are presented for purposes of additional analysis and are not a required part of the basic financial statements. The [*identify relevant supplementary information*] have been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, based on our audit and the report of other auditors, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The [*identify relevant supplementary information*] have not been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, accordingly, we express no opinion on them.

[Signature]

[Date]

Example 14A.10: Unqualified Opinions on the Basic Financial Statements of a Primary Government That Omits the Financial Data of Each Component Unit⁴⁹

(Paragraph 14.41)

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the basic financial statements of the City's primary government as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

[Same second paragraph as in Example 14A.1]

The financial statements referred to above include only the primary government of the City of Example, Any State, which consists of all funds, organizations, institutions, agencies, departments, and offices that comprise the City's legal entity. The financial statements do not include financial data for the City's legally separate component units, which accounting principles generally accepted in the United States of America require to be reported with the financial data of the City's primary government. As a result, the primary government financial statements do not purport to, and do not, present fairly the financial position of the reporting entity of the City of Example, Any State, as of June 30, 20X1, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information for the primary government of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

⁴⁹ Paragraph A.1 describes conditions that may make modifications to this report necessary.

**Example 14A.11: Unqualified Opinions on Basic
Financial Statements and on Additional Detail
Presented in the Basic Financial Statements^{50, 51}**

(Paragraph 14.46)

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. We also have audited the aggregate nonmajor governmental funds, the aggregate nonmajor enterprise funds, the internal service fund type, and each fiduciary fund type⁵² of the City of Example, Any State, as of and for the year ended June 30, 20X1, as displayed in the City's basic financial statements. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

[Same second paragraph as in Example 14A.1]

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information, as well as of the aggregate nonmajor governmental funds, the aggregate nonmajor enterprise funds, the internal service fund type, and each fiduciary fund type of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

⁵⁰ Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁵¹ This report should only be used when the financial statements subject to the more-detailed audit scope are presented in the basic financial statements. The report in Example 14A.12 should be used if the financial statements subject to the more-detailed audit scope are presented as SI.

⁵² The introductory and opinion paragraphs should list only the reporting units that are subject to the more-detailed audit scope.

Example 14A.12: Unqualified Opinions on Basic Financial Statements and on Combining and Individual Fund Financial Statements Presented as Supplementary Information^{53, 54}

(Paragraphs 14.47 and 14.51)

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. We also have audited the financial statements of each of the City's nonmajor governmental, nonmajor enterprise, internal service, and fiduciary funds presented as supplementary information in the accompanying combining and individual fund financial statements as of and for the year ended June 30, 20X1, as listed in the table of contents.⁵⁵ These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

[Same second paragraph as in Example 14A.1]

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of each nonmajor governmental, nonmajor enterprise, internal service, and fiduciary fund of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

⁵³ Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁵⁴ This report should only be used when the financial statements subject to the more-detailed audit scope are presented as SI. The report in Example 14A.11 should be used if the financial statements subject to the more-detailed audit scope are presented in the basic financial statements.

⁵⁵ The introductory and opinion paragraphs should list only the funds subject to the more-detailed audit scope.

**Example 14A.13: Unqualified Opinion on
General Fund Financial Statements⁵⁶****(Paragraphs 14.62 through 14.65)**Independent Auditor's Report

We have audited the accompanying financial statements of the general fund of the City of Example, Any State, as of and for the year ended June 30, 20X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

[Same second paragraph as in Example 14A.2]

As discussed in Note X, the financial statements present only the general fund and do not purport to, and do not, present fairly the financial position of the City of Example, Any State, as of June 30, 20X1, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.⁵⁷

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the general fund of the City of Example, Any State, as of June 30, 20X1, and the changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.⁵⁸

[Signature]

[Date]

⁵⁶ Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁵⁷ If the fund being reported on is a proprietary fund, the explanatory and opinion paragraphs also should refer to cash flows.

⁵⁸ If the general fund or a major special revenue fund presents budgetary comparison information as a basic financial statement instead of as RSI, the opinion paragraph should be modified to refer to the budgetary comparison in the manner shown in footnote 2. In addition, the explanatory paragraph would be replaced with the following: "As discussed in Note X, the financial statements present only the general fund and do not purport to, and do not, present fairly the financial position of the City of Example, Any State, as of June 30, 20X1, and changes in its financial position and budgetary comparisons for the year then ended in conformity with accounting principles generally accepted in the United States of America."

**Example 14A.14: Unqualified Opinions on
Departmental Financial Statements⁵⁹****(Paragraph 14.66)****Independent Auditor's Report**

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Department of Example, Any State, as of and for the year ended June 30, 20X1, as shown on pages XX through XX. These financial statements are the responsibility of the Department of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

[Same second paragraph as in Example 14A.1]

As discussed in Note X, the financial statements of the Department of Example, Any State, are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State that is attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of Any State as of June 30, 20X1, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information for the Department of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.⁶⁰

[Signature]

[Date]

⁵⁹ Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁶⁰ If a department presents budgetary comparison information as basic financial statements instead of as RSI, the opinion paragraph should be modified to refer to the budgetary comparison in the manner shown in footnote 31. In addition, the explanatory paragraph should be modified to refer to the budgetary comparison in the manner shown in footnote 58.

**Example 14A.15: Report on Separately Issued Summary
Financial Information Prepared in Accordance
With the Guidance in Paragraph 14.71⁶¹**

(Paragraphs 14.68 through 14.75)

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1 (not presented herein), which collectively comprise the City's basic financial statements, and have issued our report thereon dated *[indicate date]*.⁶²

As explained in Note X, the accompanying summary financial information of the City of Example, Any State, as of and for the year ended June 30, 20X1, as listed in the table of contents, is not a presentation in conformity with accounting principles generally accepted in the United States of America. In our opinion, the accompanying summary financial information is fairly stated, in all material respects, in relation to the portion of the basic financial statements from which it has been derived.

[Signature]

[Date]

⁶¹ Paragraph A.1 describes conditions that may make modifications to this report necessary.

⁶² As indicated in paragraph 14.73, the report should describe any modification of the standard report on the basic financial statements.

Chapter 15

Comprehensive Bases of Accounting Other Than Generally Accepted Accounting Principles

Accounting and Financial Reporting

15.01 Many governments, especially smaller governments, prepare financial statements in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP). Financial statements prepared in this manner are referred to as OCBOA financial statements. (OCBOA is an acronym for *other comprehensive basis of accounting*.) Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04), identifies comprehensive bases of accounting other than GAAP. The bases that are applicable to governmental financial statements are (a) a basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject, (b) the cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets, and (c) a definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.¹

15.02 As discussed in Chapters 4, “Planning the Audit,” 13, “Concluding the Audit,” and 14, “Audit Reporting,” auditors should plan, perform, evaluate the results of, and report on audits of a government’s GAAP-basis basic financial statements based on opinion units. The auditor also should apply those requirements concerning opinion units to audits of OCBOA financial statements.

15.03 SAS No. 62 (AU sec. 623.10) requires that when OCBOA financial statements contain items that are the same as or similar to those in financial statements prepared in conformity with GAAP, similar informative disclosures are appropriate. Interpretation No. 14, “Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting,” of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.90–.95), provides guidance concerning that requirement. The Interpretation (AU sec. 9623.92) states that the financial statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations; the Interpretation provides the example of disclosing the repayment terms of significant long-term borrowings if that sufficiently communicates information about future principal reduction without providing the summary of principal reduction during each of the next five years that would be required for a GAAP presentation.

¹ Preparers and auditors should consider reviewing the AICPA’s Practice Aid, *Preparing and Reporting on Cash and Tax Basis Financial Statements*.

15.04 Interpretation No. 14 of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.91) states that if GAAP sets forth requirements that apply to the presentation of financial statements, then cash basis and modified cash basis statements should either comply with those requirements or provide information that communicates the substance of those requirements. The Interpretation also states that the substance of GAAP presentation requirements may be communicated using qualitative information and without modifying the financial statement format. Generally, that guidance does not permit OCBOA financial statements to omit required basic financial statements or to substitute substantially similar information for a basic financial statement that is required by GAAP.² Instead, it permits the substitution of substantially similar information for required display within those financial statements. For example, GAAP generally require that basic financial statements present government-wide financial statements,³ columnar presentations based on major funds, and separate identification of special and extraordinary items. OCBOA financial statements should include similar government-wide financial statements and columnar presentations of major funds. (In governmental financial statements, major funds are considered separate “reporting units” equivalent to a required basic financial statement rather than a required display element within the basic financial statements.) However, required line item presentations of special and extraordinary items could be disclosed in a note to the financial statements. If required basic financial statements are not presented, or information that would be provided by required display elements is not communicated, the auditor should modify the opinion(s) on the financial statements. Whether the modifications would be qualified, adverse, or disclaimers of opinions depends on materiality of the omitted financial statement or information to the affected opinion units.

15.05 If a government issues financial statements using the cash or modified cash basis of accounting, those financial statements should be accompanied by required supplementary information (RSI) applicable to the presentation and may be accompanied by supplementary information other than RSI, known as SI. The auditor’s responsibility for and reporting on that information is the same as for RSI and SI that accompanies financial statements prepared in conformity with GAAP, as discussed in Chapters 4 and 14.

15.06 SAS No. 62 (AU sec. 623.05) lists elements required in an auditor’s report on financial statements prepared in conformity with an OCBOA. Notable among those required elements are (a) a paragraph that states the basis of presentation, refers to the note to the financial statements that describes the basis, and states that the basis of presentation is a comprehensive basis of accounting other than GAAP and (b) if the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency, a separate paragraph at the end of the report

² See, however, Interpretation No. 14, “Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting,” of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.92), which provides that cash basis and modified cash basis financial statements that include a presentation consisting entirely or mainly of cash receipts and disbursements need not conform with the requirements for a statement of cash flows that would be included in a presentation in conformity with generally accepted accounting principles (GAAP).

³ As discussed in Chapter 12, “Special-Purpose and State Governments,” GASB Statement No. 34 provides that special-purpose governments engaged only in business-type activities should present the financial statements required for enterprise funds and that special-purpose governments engaged only in fiduciary activities should present the financial statements required for fiduciary funds. Those special-purpose governments are not required to present government-wide financial statements.

stating that the report is intended solely for the information and use of those within the entity and the regulatory agencies to whose jurisdiction the entity is subject,⁴ and is not intended to be and should not be used by anyone other than these specified parties. An example of an unqualified opinion on modified cash basis financial statements is shown in Example 15.1 in paragraph 15.07.

Illustrative Auditor's Report

15.07 Example 15.1 illustrates the auditor's report on OCBOA financial statements. Auditors should modify the illustrative report as needed in different situations. Paragraph A.1 in Appendix A, "Illustrative Auditor's Reports," in Chapter 14 describes conditions that may make modifications necessary.

Example 15.1

Unqualified Opinions on Modified Cash Basis Financial Statements⁵

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As discussed in Note X, the City of Example, Any State, prepares its financial statements on the modified cash basis, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

⁴ SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.05f, footnote 5), requires that if the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, the auditor should follow the guidance in SAS No. 1, section 544, "Lack of Conformity With Generally Accepted Accounting Principles," as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 544).

⁵ If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject and intended solely for use by those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, the opinion paragraph should be followed by a paragraph that restricts the use of the report solely to those within the entity and for filing with the regulatory agency. See paragraph 15.06 of this chapter and SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.05f and .08).

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position—modified cash basis of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position—modified cash basis thereof for the year then ended in conformity with the basis of accounting described in Note X.

[Signature]

[Date]

Transition to GASB Statement No. 34

15.08 Because of the requirements of SAS No. 62 as explained in this chapter, governments that issue cash or modified cash basis financial statements generally will need to modify their financial statement presentations and disclosures for the effects of GASB Statement No. 34 and related pronouncements. Chapter 2, “Financial Reporting,” in the section on transition to GASB Statement No. 34, discusses the required effective dates of GASB Statement No. 34 and explains how a government that issues cash or modified cash basis financial statements might determine its implementation phase.

Chapter 16

Auditor Association With Municipal Securities Filings

Introduction

16.01 Governments generally issue debt securities—known as *municipal securities*—through negotiated sales, competitive bids, or private placements. In a negotiated sale, the government negotiates a price with one or more underwriters. In a competitive bid sale, the government sells the securities to one or more underwriters who submitted the best acceptable bid. The underwriters then resell the securities to the public. In a private placement, which frequently occurs for small issues, the government sells the securities directly to the investor, usually a local bank.

16.02 A government that is selling securities prepares an official statement¹ that offers the securities for sale and provides appropriate financial and other information about the offering and the government. Financial advisors and bond counsel and, frequently, engineers, appraisers, and independent auditors, assist the government in preparing information for the official statement. The following are important stages in a municipal securities offering; the time periods between these stages may vary:

- The preliminary official statement is issued to all prospective buyers of the securities.
- The official statement is issued at the time of sale (sometimes referred to as the effective date) and identifies the buyers and the actual debt service requirements of the securities.
- The closing date is the date the transaction is finalized and the cash is transferred from the buyers to the government.

16.03 Municipal securities are exempt from all of the provisions of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) except the antifraud provisions of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act (and the associated Rule 10b-5). Those antifraud provisions prohibit any person from misrepresenting or omitting material facts in the offering or sale of securities.

16.04 The SEC's Rule 15c2-12 (17 Code of Federal Regulations [CFR] Part 240.15c2-12) and associated SEC Releases impose certain requirements on the underwriters of municipal securities. Because of Rule 15c2-12, issuers of most municipal securities offerings over set dollar amounts provide certain disclosures when issuing securities (primary market disclosures) as well as at certain times thereafter (continuing disclosures²). Primary market disclosures are made by issuing an official statement. Continuing disclosures are made by providing to certain distributing organizations³ (a) annual continuing

¹ *Official statement* is the common term used for the offering document or offering circular for municipal securities.

² Some literature also refers to continuing disclosures using the term *secondary market disclosures*.

³ These distributing organizations include nationally recognized municipal securities information repositories (NRMSIRs) and a state information depository (SID), if one exists in the issuer's state.

disclosures as contractually established and (b) material events notices. Annual continuing disclosures are financial information, including audited financial statements, that are updated annually. Material events notices, which are required for eleven specific events with respect to municipal securities, such as principal and interest payment delinquencies and nonpayment related defaults, are provided through a press release or other written notification on an "as-needed" basis and do not involve financial statements. Issuers are required to notify distributing organizations of material events in a "timely" manner.

16.05 In its Release No. 33-7049 and 34-33741,⁴ *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, the SEC recommends that governments consult the Government Finance Officers Association's *Disclosure Guidelines for State and Local Government Securities* and other guidance, such as the National Federation of Municipal Analysts' *Disclosure Handbook for Municipal Securities*, for recommendations about the type of information to include in official statements and continuing disclosure documents.

Auditor Association

Required Association

16.06 Because there is no Securities and Exchange Commission (SEC) requirement for auditor association with governmental official statements, an auditor generally is not required to participate in, or undertake any procedures with respect to, a government's official statement.⁵ However, the auditor becomes associated with the official statement when involved in certain situations and should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550). SAS No. 8 provides guidance on the auditor's responsibilities for information in those official statements other than the financial statements covered by the auditor's opinion. (See the overview of the SAS No. 8 provisions in paragraph 16.07.) The following are the situations in which the auditor becomes associated with the official statement:

- Assisting in preparing the financial information⁶ included in the official statement
- Reviewing a draft of the official statement at the government's request
- Manually signing the independent auditor's report included in the official statement⁷

⁴ Note that the Securities and Exchange Commission (SEC) release is one release that has two numbers—one for the 1933 Act and one for the 1934 Act.

⁵ Some auditors require that they become associated with a government's official statements even though the conditions described in this paragraph establishing association would not otherwise exist. See the discussion at paragraph 16.10.

⁶ For the purpose of this requirement, *financial information* does not include the financial statements covered by the auditor's opinion or the required supplementary information (RSI) or supplementary information other than RSI (known as SI) accompanying those financial statements that the auditor already considered during his or her audit of the financial statements.

⁷ This situation involves an original manual signature on the auditor's report, not a reproduction of an auditor's report that was manually signed. For example, the underwriter or bond counsel may require a copy of the auditor's report with an original manual signature to file with the official closing documents for the offering.

- Providing a revised independent auditor's report⁸ for inclusion in a specific official statement
- Issuing a comfort letter, the letter described in SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 634.09), or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement (See paragraphs 16.12 through 16.15.)
- Providing written agreement for the use of the independent auditor's report in the official statement (See paragraphs 16.16 through 16.19.)
- Issuing a report on an attestation engagement relating to the debt offering (See paragraph 16.20.)

16.07 If the auditor is associated with an official statement, the guidance in SAS No. 8 provides that the auditor has no obligation to perform any procedures to corroborate other information⁹ contained in those documents. However, the auditor should read the other information and consider whether that information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. SAS No. 8 (AU sec. 550.04–.06) provides guidance if the auditor concludes there is a material inconsistency or a material misstatement of fact that is not a material inconsistency.

16.08 SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380.12), requires the auditor to discuss with the audit committee or formally designated group equivalent to the audit committee his or her responsibility for other information in documents containing audited financial statements, any procedures performed, and the results. That requirement pertains to the financial statements currently being issued, and thus would not apply retroactively to official statements. However, that communication could supply that information for official statements issued during the current audit period and through the auditor's report date, whether or not the auditor was associated with those official statements.

16.09 The auditor is not required to participate in, or undertake any procedures with respect to, a government's continuing disclosure documents, even though they may include audited financial statements. A government's continuing disclosures are not required to be submitted to or disseminated from the distributing organizations as a single document. Thus, an auditor's association with other information encompassed by such disclosures cannot be clearly established. Therefore, the provisions of SAS No. 8 do not apply to documents that contain those disclosures. Any attention the auditor devotes to other information included with audited financial statements in continuing disclosure documents at the government's request should be considered a consulting engagement under the provisions of the AICPA Statement on

⁸ A revised report would, for example, eliminate the references made by the auditor in the original report to (a) RSI or SI that had accompanied the basic financial statements or (b) the audit and reports required by *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States.

⁹ *Other information* is a term used in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), and is defined therein as information in addition to audited financial statements and the independent auditor's report thereon. "Other information" is referred to elsewhere in this Guide as SI because of references in GASB pronouncements to that information using the term *supplementary information*. The auditor's responsibility for and reporting on SI are further discussed in Chapters 4, "Planning the Audit," and 14, "Audit Reporting," respectively.

Standards for Consulting Services (SSCS) No. 1, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100).

Auditor-Required Association

16.10 Although an auditor is not required to become associated with a government's official statements except in the situations described in paragraph 16.06, some auditors include a provision in the engagement letter requiring the government to obtain permission from the auditor before using the independent auditor's report in the official statement. Such a provision establishes a requirement that the auditor become associated with the government's official statements.

Using Government Auditing Standards Reports and References in the Official Statement

16.11 If the auditor is associated with a government's official statements, he or she should consider which auditors' reports the government presents in the official statement. The official statement should not include the reports required by *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States, because those reports are restricted-use reports under the provisions of SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). Further, it generally is advisable for the official statements to use an auditor's report on the financial statements that does not refer to the *Government Auditing Standards* audit or to those reports because those references, without the presentation of the reports in the official statements, could confuse the users of the official statement.

Letters for Underwriters

16.12 Underwriting agreements between a government and its underwriters may require the auditor to prepare a comfort letter addressed to the underwriters. SAS No. 72, as amended (AU sec. 634), defines the term *underwriters* and gives guidance to auditors¹⁰ in providing letters to underwriters and to certain other requesting parties in connection with the offering or placement of securities. An auditor may provide a comfort letter to a broker-dealer or other financial intermediary acting as principal or agent in offerings of securities issued or backed by governmental entities exempt from registration under the 1933 Act only if the broker-dealer or other financial intermediary provides the required representation letter. The required elements of the representation letter from the broker-dealer or other financial intermediary are as follows:

- The letter should be addressed to the auditor.
- The letter should contain the following:

This review process, applied to the information relating to the issuer, is (will be) substantially consistent [footnote omitted] with the due diligence review process that we would perform if this placement of securities (or issuance of securities in an acquisition transaction) were

¹⁰ Because of its use in SEC literature, certain auditing literature uses the term *accountant* to refer to the auditor. However, this chapter replaces the term *accountant* with the term *auditor*.

being registered pursuant to the Securities Act of 1933 (the Act). We are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act. [footnote omitted]

- The letter should be signed by the requesting broker-dealer or other financial intermediary.

16.13 When a party requesting a comfort letter has provided the auditor with the required representation letter, the auditor should refer in the comfort letter to the requesting party's representations. See example P in the appendix to SAS No. 72, as amended (AU sec. 634.64), which is a typical comfort letter in a non-1933 Act offering, including the required underwriter representations. If the required representation letter is not provided by the broker-dealer or other financial intermediary, auditors who are requested to issue letters in conjunction with securities offerings should follow the guidance SAS No. 76, *Amendments to Statement on Auditing Standards No. 2, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634.09). When a comfort letter is requested by a party other than the underwriter, broker-dealer, or other financial intermediary, the auditor should not provide that party with a comfort letter or the letter described in SAS No. 76 (AU sec. 634.09). Instead, the auditor may provide the party with a report on agreed-upon procedures and should refer to Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, Chapter 2, "Agreed-Upon Procedures Engagements" (AICPA, *Professional Standards*, vol. 1, AT sec. 201), for guidance. (See AICPA, *Professional Standards*, vol. 1, AU sec. 634.06–.10.)

16.14 SAS No. 72, as amended (AU sec. 634.37), requires the auditor to perform a review, as discussed in SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), to provide negative assurance in a comfort letter on interim financial information. If the auditor has not performed such a review, SAS No. 72 (AU sec. 634.37 and .47) prohibit the auditor from giving negative assurance with respect to whether any material modifications should be made to the interim financial information for it to be in conformity with generally accepted accounting principles (GAAP) and from providing negative assurance as to subsequent changes in financial statements items from the date of the interim financial information. Instead, the auditor is limited to stating procedures performed and findings obtained. The letter should specifically state that the auditor has not audited the interim financial information in accordance with generally accepted auditing standards (GAAS) and does not express an opinion concerning such information. An example of that language is in the third paragraph of the example A comfort letter in AICPA, *Professional Standards*, vol. 1, AU sec. 634.64.

16.15 When the auditor is asked to prepare a letter for the underwriter, the letter can be as of the preliminary official statement date or the official statement date (as defined in paragraph 16.02), with updating letters issued as of the official statement date (if applicable) and the closing date. SAS No. 72 (AU sec. 634.23) states that the underwriting agreement ordinarily specifies the date, often referred to as the "cutoff date," to which certain procedures described in the letter are to relate (for example, a date five days before the date of the letter). The letter should state that the inquiries and other procedures described in the letter did not cover the period from the cutoff date to the date of the letter. The five-day cut-off period in SAS No. 72 is illustrative only and does not set a standard, but practice generally does not exceed a five-day cut-off period.

Auditing Interpretations Regarding Governmental Official Statements

16.16 The AICPA has issued Interpretations to SAS No. 37 that address the auditor's agreement¹¹ to (a) being named in and (b) the use of an auditor's report in an offering document other than one registered under the 1933 Act.¹²

16.17 Interpretation No. 2 of SAS No. 37, "Consenting to Be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933" (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.12–.15), states that when a client wishes to make reference to the auditor's role in an offering document in connection with a securities offering that is not registered under the 1933 Act, the caption "Independent Auditors" should be used to title that section of the document; the caption "Experts" should not be used, nor should the auditor be referred to as an "expert" anywhere in the document. The following paragraph should be used to describe the auditor's role.

Independent Auditors

The financial statements as of December 31, 20XX, and for the year then ended, included in this [name of document], have been audited by ABC, independent auditor, as stated in its report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditor as an "expert," the auditor should not permit inclusion of the auditor's report in the offering document.

16.18 Interpretation No. 3 of SAS No. 37, "Consenting to the Use of an Audit Report in an Offering Document Other Than One Registered Under the Securities Act of 1933" (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.16–.17), states that the auditor is not required to but may provide an agreement to the inclusion of the auditor's report in an offering document other than one registered under the 1933 Act. The Interpretation provides the following example language that the auditor may use:

We agree to the inclusion in this [name of document] of our report, dated February 5, 20XX, on our audit of the financial statements of [name of entity].

16.19 When the auditor is asked to issue a letter agreeing to the use of the auditor's report in the offering document, the effective date of the letter can be the preliminary official statement date or the official statement date (as defined in paragraph 16.02).

Attestation Engagements Related to Municipal Securities Issuances

16.20 During the process of issuing municipal securities, governments or other involved parties often engage practitioners to provide certain needed

¹¹ The term *consent* is an SEC term that relates to registered securities, and municipal securities are not registered securities. Therefore, this Guide uses the term *agreement*, even though the AICPA Interpretations discussed refer to *consent*.

¹² As discussed in footnote 1, governments generally refer to the offering document or offering circular for municipal securities as an official statement.

information. For example, a government or its bond counsel may engage an auditor to review the government's compliance with the revenue coverage requirements on outstanding bonds or to verify the calculation of escrow account requirements for an advance refunding of bonds. Those engagements should be conducted in accordance with SSAE No. 10. If the auditor of the financial statements included in the official statement also provides an attestation engagement report relating to a debt offering, that establishes an association with the official statement, as indicated in paragraph 16.06. An attestation engagement report relating to a debt offering need not be referred to or included in the official statement to associate the auditor of the financial statements with the official statement. Sometimes, the attestation engagement report may only be included in the official closing documents for the offering. Also, if the practitioner providing the attestation engagement report is not the auditor of the financial statements included in the official statements, the issuance of the attestation engagement report does not, by itself, associate either the auditor of the financial statements or the practitioner who issued the attestation report with the official statement.

Appendix A

Acronyms and Abbreviations

AcSEC—Accounting Standards Executive Committee of the AICPA

AICPA—American Institute of Certified Public Accountants

APB—Accounting Principles Board

APC—Annual pension cost

ARB—Accounting Research Bulletin of the Committee on Accounting Procedure

ARC—Annual required contribution

AT sec.—Attestation standards section of the AICPA's *Professional Standards*

AU sec.—Auditing standards section of the AICPA's *Professional Standards*

BAN—Bond anticipation note

CAFR—Comprehensive Annual Financial Report

CFDA—Catalog of Federal Domestic Assistance

CFR—Code of Federal Regulations

CS sec.—Consulting services standards section of the AICPA's *Professional Standards*

ERISA—Employee Retirement Income Security Act

ET sec.—Ethics standards section of the AICPA's *Professional Standards*

FAA—U.S. Federal Aviation Administration

FASAB—Federal Accounting Standards Advisory Board

FASB—Financial Accounting Standards Board

FDS—HUD's Financial Data Schedule

GAAP—Generally accepted accounting principles

GAAS—Generally accepted auditing standards

GAO—United States General Accounting Office

GASB—Governmental Accounting Standards Board

GASB Q&A—Implementation Guide of the GASB staff

GWFS—Government-wide financial statements

HUD—U.S. Department of Housing and Urban Development

IBNR—Incurred but not reported (claims)

IRC—Internal Revenue Code

MD&A—Management's discussion and analysis

MFBA—Measurement focus and basis of accounting

NCGA—National Council on Governmental Accounting
NPO—Net pension obligation
NRMSIR—Nationally recognized municipal securities information repository
O&M—Expenses for operations and maintenance of plant
OCBOA—Comprehensive basis of accounting other than GAAP
OMB—U.S. Office of Management and Budget
OPEB—Other postemployment benefits
PERS—Public employee retirement system
PFC—Passenger facility charge
PBC—Prepared by client
PERS—Public Employees Retirement System
PHA—Public housing authority
PILOT—Payment in lieu of taxes
QSTP—Qualified State Tuition Program
RFP—Request for proposals
RSI—Required supplementary information
SAS—Statement on Auditing Standards
SEC—Securities and Exchange Commission
SI—Supplementary information other than required supplementary information
SID—State information depository
SOP—Statement of Position by Committees of the AICPA
SSAE—Statement on Standards for Attestation Engagements
SSCS—Statement on Standards for Consulting Services
TB—Technical Bulletins of the GASB
UBIT—Federal unrelated business income taxes
UFRS—HUD's *Uniform Financial Reporting Standards*
USDA—U.S. Department of Agriculture
YELLOW BOOK—*Government Auditing Standards*, issued by Comptroller General of the U.S., 1994, as amended

Appendix B

Category B Guidance

As discussed in Chapter 1, “Overview and Introduction,” Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, as amended by SAS No. 91, *Federal GAAP Hierarchy* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), establishes a hierarchy of generally accepted accounting principles (GAAP) applicable to state and local governmental entities that indicates the level of authority of various sources. Category (b) guidance includes AICPA Industry Audit and Accounting Guides specifically made applicable to state and local governmental entities by the AICPA and cleared by the GASB, such as this Guide. This appendix lists the category (b) guidance in this Guide.

Location	Nature of Guidance
Paragraph 1.01 and footnote 4	Definition of government
Paragraph 2.56, third and fourth sentences	Amounts due from other funds are not appropriately restricted for debt service
Paragraph 5.06, last sentence	Annual calculation of an arbitrage liability
Paragraph 5.21, first part of third sentence	Reporting other governmental fund investments using cost-based measures
Paragraph 5.21, last three sentences	Loss recognition on investments reported using cost-based measures for other-than temporary declines in fair value
Paragraph 5.26	Overdrafts of internal investment pools and of cash accounts
Paragraph 5.28	Interfund balances relating to agency funds with negative cash balances
Paragraph 6.34, last two sentences	Loss contingencies for questioned costs on intergovernmental grants
Paragraph 6.73, second sentence	Reporting nonoperating revenue for certain nonexchange revenues for operating purposes or for operating purposes or capital outlay at the recipient's discretion
Paragraph 7.45	Interfund movements of capital assets
Paragraph 8.16	When to report the issuance of debt
Paragraph 8.34, fourth sentence	Reporting revenue for fees received for administering pass-through grants
8.47, second sentence	Tax refund claims and refunds of nonexchange revenues when the government does not meet a provider's requirements as examples of loss contingencies
Paragraph 8.54	Accounting for customer deposits for utility services
Paragraph 8.56, fifth sentence	Write-downs of governmental fund inventories for physical deterioration or obsolescence
Paragraph 8.82, first sentence	Definition of a commitment
Paragraph 10.10, first sentence	Examples of fund balance reserves

Location	Nature of Guidance
Paragraph 10.14	Reporting governmental fund balance reserves for inventories and prepaid items that are accounted for using the consumption method
Paragraph 10.17, seventh sentence	Designations should not result in reporting negative undesignated governmental fund balances
Paragraph 11.16, last sentence	Disclosure in the notes to the financial statements if a budget is not adopted for the general or a major special revenue fund because it is not legally required
Paragraph 12.31, fourth sentence	Revenues and expenses that financing authorities should report in their financial statements
Paragraph 12.70, second sentence	Reporting nonoperating revenue for appropriations for operating purposes or for operating purposes or capital outlay at the recipient's discretion
Paragraph 12.104, first sentence	Accounting for lottery prize costs
Paragraph 12.105	Using present value to measure lottery prize liabilities; accounting for prize liabilities for which annuities have been purchased
Paragraph 12.106; first sentence	Using present value to measure lottery prize liabilities
Paragraph 14.56, footnote 19	Disclosure in the notes to the financial statements if a budget is not adopted for the general or a major special revenue fund because it is not legally required
Appendix C	<i>Statement of Position 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising</i>

Appendix C

**Statement of
Position**

98-2

**Accounting for Costs of
Activities of Not-for-Profit
Organizations and State and
Local Governmental Entities
That Include Fund Raising**

March 11, 1998

**Amendment to
AICPA Audit and Accounting Guides
*Health Care Organizations,
Not-for-Profit Organizations, and
Audits of State and Local Governmental Units***

**Issued by the Accounting
Standards Executive Committee**

AAG-SLV APP C

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Statements of Position that have been cleared by either the Financial Accounting Standards Board (for financial statements of nongovernmental entities) or the Governmental Accounting Standards Board (for financial statements of state and local governmental entities), as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.
- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.*

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

* This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object.

Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

Introduction

1. Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,¹ such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities**.² These activities include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities**.^{3*} Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

¹ This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

² Terms that appear in the Glossary are set in **boldface type** the first time they appear.

³ The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D-5 of this SOP, those entities are required to report fund raising as part of the “institutional support” function.)

* The AICPA Audit and Accounting Guides *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* were superseded by the 1996 edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. However, because the accounting guidance contained in these Guides remained applicable to certain governmental entities (pursuant to the provisions of GASB Statement Nos. 15, *Governmental College and University Accounting and Financial Reporting Models*, and 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*), the AICPA continued to make these Guides available for sale.

With the recent issuance of GASB Statement Nos. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, and 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*, which supersede the effect of GASB Statement Nos. 15 and 29, it is no longer necessary for the AICPA to continue selling these Guides.

Accordingly, *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* will no longer be included as part of this loose-leaf publication.

Once the phased-in effective dates of the GASB Statements have occurred, the accounting guidance in these Guides will no longer be applicable to any governmental entities. Please note that the Guides have not been updated since 1994. Therefore, if you already have a Guide, and choose to continue using it until the phase-in period is complete, you must consider guidance issued since they were last updated.

2. External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

3. In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*.⁴ SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those materials and activities and that certain criteria be applied in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

4. The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B, “Background,” discusses this further.)

5. This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F provides explanations and illustrations of some acceptable allocation methods.

Scope

6. This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

Conclusions

Accounting for Joint Activities

7. If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported

⁴ In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. *Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

Purpose

8. The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs 9 and 10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph 9 provides guidance pertaining to program functions only. Paragraph 10 provides guidance pertaining to both program and management and general functions.)

9. *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity's mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity's mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)

- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph 10 should also be considered in determining whether the purpose criterion is met.

10. Program and management and general functions. The following factors should be considered, in the order in which they are listed,⁵ to determine whether the purpose criterion is met:

- Whether **compensation or fees** for performing the activity are based on contributions raised.* The purpose criterion is *not* met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.^{6, 7}
- Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

- The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and
- A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.⁸

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.

⁵ In considering the guidance in paragraph 10, the factor in paragraph 10a (the compensation or fees test) is the preeminent guidance. If the factor in paragraph 10a is not determinative, the factor in paragraph 10b (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph 10b is not determinative, the factor in paragraph 10c (other evidence) should be considered.

⁶ Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is \$10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

⁷ The *compensation or fees test* is a negative test in that it either (a) results in failing the purpose criterion or (b) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph 10b should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph 10b should be considered.

⁸ Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

If the purpose criterion is met based on the factor in paragraph 10b, the factor in paragraph 10c should not be considered.

- c. *Other evidence.* If the factors in paragraph 10a or 10b do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

11. The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

- a. Evidence that the purpose criterion may be met includes—
 - *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).
 - *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.
- b. Evidence that the purpose criterion may not be met includes—
 - *Evaluation or compensation.* The facts may indicate that the purpose criterion is not met if (a) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (b) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.
- c. Evidence that the purpose criterion may be either met or not met includes—
 - *Evaluation of measured results of the activity.* The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
 - *Qualifications.* The qualifications and duties of those performing the joint activity should be considered.
 - If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity

should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.

- If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (a) employees who are not members of the fund-raising department and (b) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.
- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
 - The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
 - Minutes of board of directors', committees', or other meetings.
 - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
 - Long-range plans or operating policies.
 - Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
 - Internal management memoranda.

Audience

12. A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph 13a, 13b, or 13c. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph 13a, 13b, or 13c. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

13. In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

- a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity

- b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity
- c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

Content

14. The content criterion is met if the joint activity supports program or management and general functions, as follows:

- a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.
- b. *Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.⁹

15. Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

Allocation Methods

16. The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

Incidental Activities

17. Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [address]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [a particular cause]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We

⁹ Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

recently changed our phone number. Our new number is 123-4567”—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

Disclosures

18. Entities that allocate joint costs should disclose the following in the notes to their financial statements:

- a. The types of activities for which joint costs have been incurred
- b. A statement that such costs have been allocated
- c. The total amount allocated during the period and the portion allocated to each functional expense category

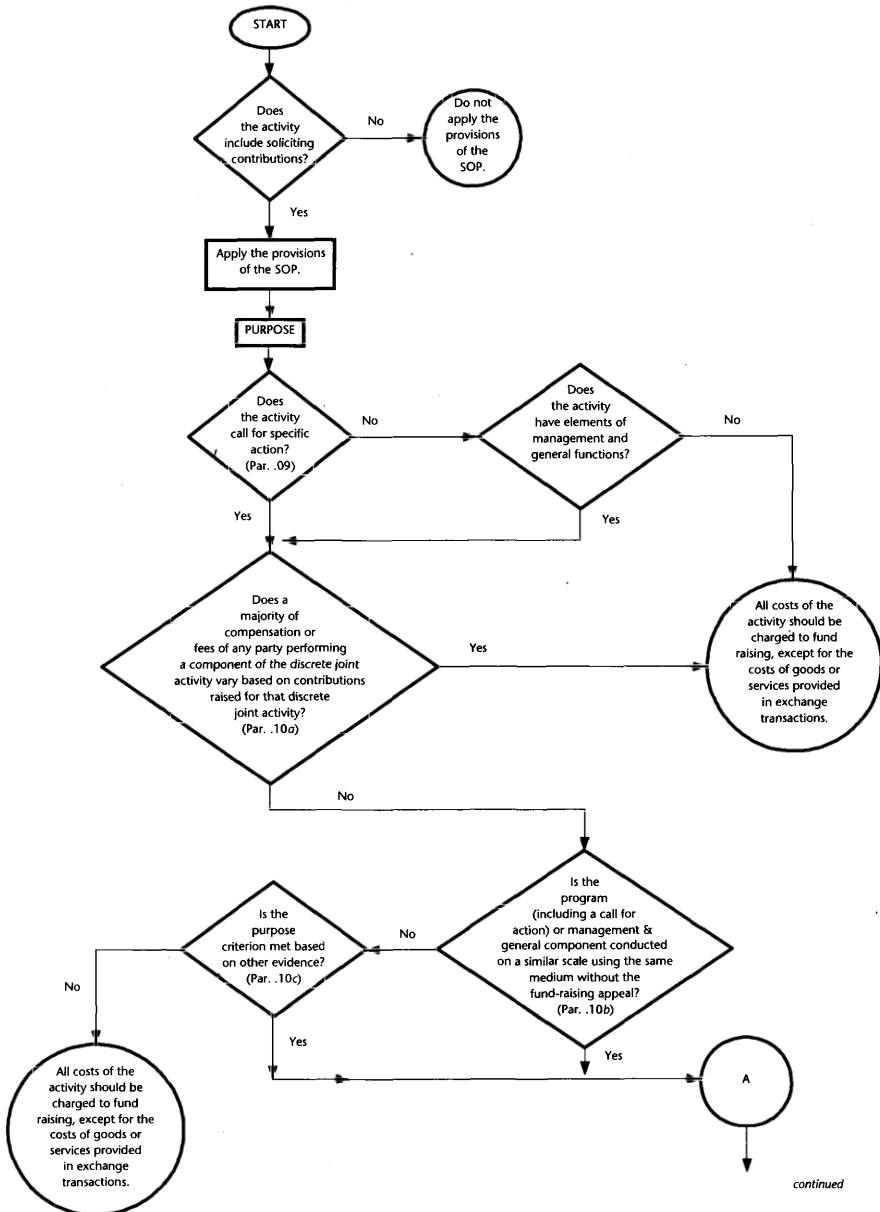
19. This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

Effective Date

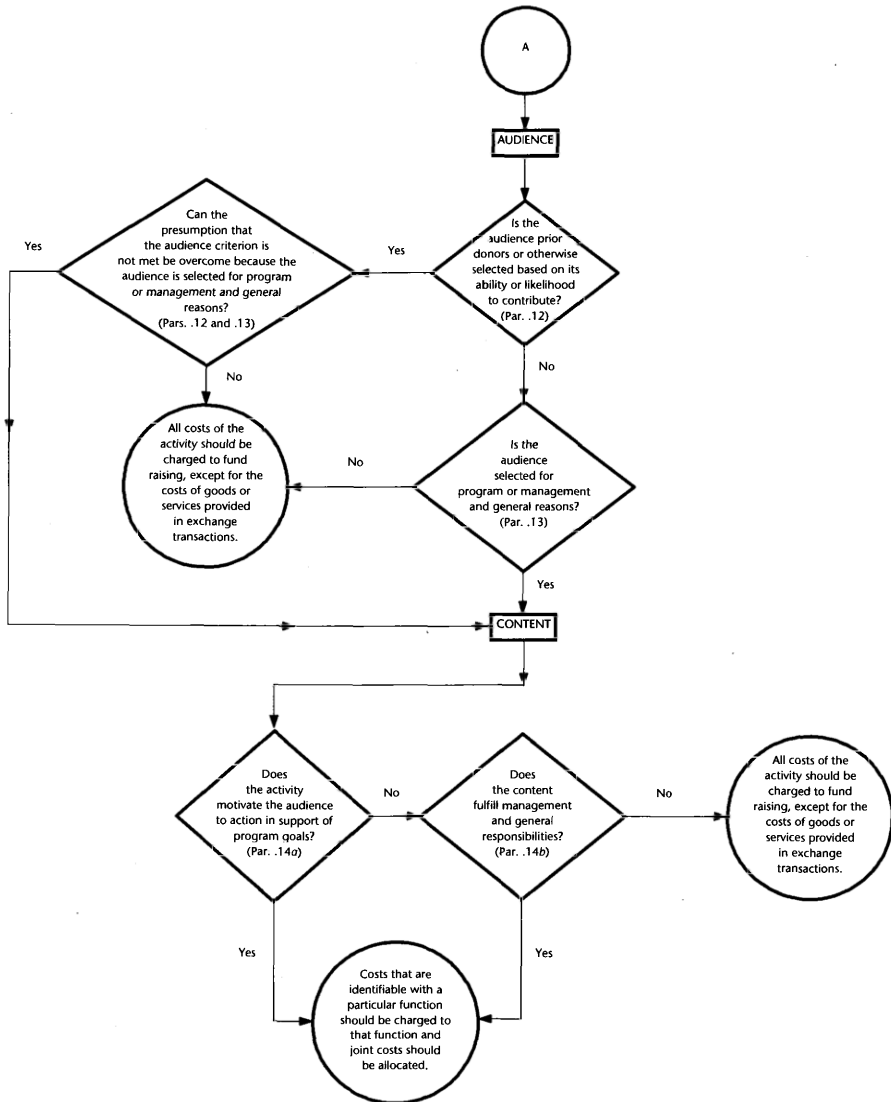
20. This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

<p>The provisions of this Statement of Position need not be applied to immaterial items.</p>

APPENDIX A

Accounting for Joint Activities¹⁰

¹⁰ **Note:** This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.



APPENDIX B

Background

B.1. As stated in paragraph 4, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that “some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services.” It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

B.2. In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

B.3. In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

B.4. Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process sub-

sequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

B.5. Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

B.6. Appendix C discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

APPENDIX C

Basis for Conclusions

C.1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Overall Framework

C.2. This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

C.3. On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

C.4. AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

C.5. Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public information and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

C.6. Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

Accounting for Joint Activities

C.7. This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

C.8. Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

C.9. AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general,

depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

C.10. AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

Criteria of Purpose, Audience, and Content

Call For Action

C.11. The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (a) the purpose of the activity include educating the public about causes, (b) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (c) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph 9, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

Purpose

C.12. AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

Compensation and Evaluation Tests

C.13. The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (a) substantially all compensation or fees for performing the activity are based on amounts raised or (b) the evaluation of the party performing the activity is based on amounts raised. Some respondents commented that basing the method of compensation or evaluating the performance

of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

C.14. AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of “based on contributions raised” included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party’s performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

C.15. AcSEC believes that the guidance in paragraph 10a is not biased against entities that hire professional fund raisers, because it applies to the entity’s employees as well as professional fund raisers. For example, if a majority of an employee’s compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

Similar Function-Similar Medium Test

C.16. Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph 11. AcSEC has revised the SOP to state this more clearly.

Other Evidence

C.17. The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

Audience

C.18. The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

C.19. AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph 13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

Content

C.20. AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

C.21. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

C.22. Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

C.23. As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

C.24. Paragraph 13c provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph 14b provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph 14b provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (a) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (b) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (a) requirements that must be met as a result of receiving contributions and (b) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

Incidental Activities

C.25. Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such program

or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

Allocation Methods

C.26. Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

C.27. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that “the term *accounting principle* includes ‘not only accounting principles and practices but also the methods of applying them.’” APB Opinion 20 also states in paragraphs 15 and 16 that

... In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type ... The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph 16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

Disclosures

C.28. Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures

and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

C.29. Paragraph 19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

Effective Date

C.30. Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

Cost-Benefit

C.31. Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

APPENDIX D

Discussion of Conclusions

Scope

D.1. This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

Reporting Models and Related Requirements

D.2. Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.35 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses.

D.3. Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations** (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.

* The AICPA Audit and Accounting Guides *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* were superseded by the 1996 edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. However, because the accounting guidance contained in these Guides remained applicable to certain governmental entities (pursuant to the provisions of GASB Statement Nos. 15, *Governmental College and University Accounting and Financial Reporting Models*, and 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*), the AICPA continued to make these Guides available for sale.

With the recent issuance of GASB Statement Nos. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, which superseded the effect of GASB Statement Nos. 15 and 29, it is no longer necessary for the AICPA to continue selling these Guides.

Accordingly, *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* will no longer be included as part of this loose-leaf publication.

Once the phased-in effective dates of the GASB Statements have occurred, the accounting guidance in these Guides will no longer be applicable to any governmental entities. Please note that the Guides have not been updated since 1994. Therefore, if you already have a Guide, and choose to continue using it until the phase-in period is complete, you must consider guidance issued since they were last updated.

D.4. GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*,* as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)

D.5. For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*,* as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*,* as amended by SOP 74-8, are required to report fund raising as part of the "institutional support" function.

D.6. As discussed in footnote 3 to paragraph 1 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund

* The AICPA Audit and Accounting Guides *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* were superseded by the 1996 edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. However, because the accounting guidance contained in these Guides remained applicable to certain governmental entities (pursuant to the provisions of GASB Statement Nos. 15, *Governmental College and University Accounting and Financial Reporting Models*, and 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*), the AICPA continued to make these Guides available for sale.

With the recent issuance of GASB Statement Nos. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, which superseded the effect of GASB Statement Nos. 15 and 29, it is no longer necessary for the AICPA to continue selling these Guides.

Accordingly, *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* will no longer be included as part of this loose-leaf publication.

Once the phased-in effective dates of the GASB Statements have occurred, the accounting guidance in these Guides will no longer be applicable to any governmental entities. Please note that the Guides have not been updated since 1994. Therefore, if you already have a Guide, and choose to continue using it until the phase-in period is complete, you must consider guidance issued since they were last updated.

raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

Assigning Costs of Joint Activities

D.7. Paragraph 7 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity. . . ." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

Educational Activities

D.8. Some entities have missions that include educating the public (students) in areas other than causes. Paragraph 9 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action

that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

D.9. AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

Audience

D.10. Paragraph 12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph 13. Further, paragraph 12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost \$500 to attend a dinner with a fair value of \$50. In that case, the audience is required to make a \$450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph 13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

D.11. The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

D.12. Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide

services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

D.13. Paragraph 13c provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

Content

D.14. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary, the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

- a. Actions that benefit the recipient:
 - *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
 - *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.
- b. Actions that benefit society:
 - *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
 - *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
 - *Boycott.* The particular product or company to be boycotted should be specified.

D.15. Paragraph 14b provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph 14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [the state] by calling 123-4567. Registration with the attorney general does not imply endorsement.

- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

Allocation Methods

D.16. Paragraph 16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

Practicability of Measuring Joint Costs

D.17. The Glossary of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

APPENDIX E

Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

Illustration 1

Facts

E.1. Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

E.2. Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

E.3. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.4. The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph 10b.)

E.5. The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.6. The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Illustration 2

Facts

E.7. Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

E.8. Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

E.9. The purpose and content criteria are met. The audience criterion is not met.¹¹ All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

E.10. The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

¹¹ Paragraph 7 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

E.11. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

E.12. The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 3

Facts

E.13. Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

E.14. Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

Conclusion

E.15. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.16. The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (b) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (c) performing such programs helps accomplish Entity C's mission.

E.17. The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

E.18. The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for re-

search about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 4

Facts

E.19. Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

E.20. Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

E.21. The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

Conclusion

E.22. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

E.23. The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) performing such programs helps accomplish Entity D's mission, and (b) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

E.24. The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.25. The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Illustration 5

Facts

E.26. The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion

E.27. The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Illustration 6

Facts

E.28. Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

E.29. Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

E.30. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.31. The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and

programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (b) performing such programs helps accomplish Entity F's mission (to protect the environment).

E.32. The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.33. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Illustration 7

Facts

E.34. Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

E.35. Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

E.36. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.37. The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

E.38. The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

E.39. The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Illustration 8

Facts

E.40. Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

E.41. Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

Conclusion

E.42. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.43. The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (b) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

E.44. The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

E.45. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Illustration 9

Facts

E.46. Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

E.47. Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the

needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid \$25,000 for this activity, with a \$5,000 bonus if the activity raises over \$1,000,000.

Conclusion

E.48. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.49. The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph 10a were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid \$5,000 if the activity raises over \$1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because \$5,000 would not be a majority of the executive producer's total compensation of \$30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph 11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

E.50. The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

E.51. The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

Illustration 10

Facts

E.52. Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of

operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

E.53. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.54. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (b) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

E.55. The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

E.56. The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Illustration 11

Facts

E.57. Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of \$75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

E.58. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

E.59. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

E.60. The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

E.61. The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Illustration 12

Facts

E.62. Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (a) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (b) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

E.63. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.64. The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity L's mission.

E.65. The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

E.66. The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Illustration 13

Facts

E.67. Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

E.68. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.69. The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (b) it otherwise conducts the program activity without a request for contributions, and (c) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

E.70. The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.71. The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Illustration 14

Facts

E.72. Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture

and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

Conclusion

E.73. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.74. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

E.75. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

E.76. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.¹²)

¹² Paragraphs 13.22 to 13.27 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

Illustration 15

Facts

E.77. Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at \$250, which is above the \$50 fair value of the lecture and, therefore, \$200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

Conclusion

E.78. The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

E.79. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

E.80. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the \$250 admission price includes a \$200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

E.81. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.¹³)

¹³ Paragraphs 13.22 to 13.27 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

Illustration 16

Facts

E.82. Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

E.83. Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

E.84. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.85. The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (b) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (c) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (d) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

E.86. The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.87. The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 17

Facts

E.88. Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station

and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

E.89. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

E.90. The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

E.91. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

E.92. The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

APPENDIX F

Illustrations of Allocation Methods

F.1. Some commonly used cost allocation methods follow.

Physical Units Method

F.2. Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

F.3. Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

F.4. The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

F.5. Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

F.6. The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total \$20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total \$80,000. Joint costs associated with the direct mail campaign total \$40,000 and would be allocated as follows under the relative direct cost method:

Program	$\$20,000/\$100,000 \times \$40,000 = \$8,000$
Fund raising	$\$80,000/\$100,000 \times \$40,000 = \$32,000$

Stand-Alone Joint-Cost-Allocation Method

F.7. Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

F.8. Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of \$100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been \$90,000 for the program component and \$70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the \$100,000 in joint costs would be allocated as follows: $\$90,000/\$160,000 \times \$100,000 = \$56,250$ to program services and $\$70,000/\$160,000 \times \$100,000 = \$43,750$ to fund raising.

APPENDIX G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs 18 and 19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of \$310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). *[Note to reader: The following sentence is encouraged but not required.]* Joint costs for each kind of activity were \$50,000, \$150,000, and \$110,000 respectively. These joint costs were allocated as follows:

Fund raising	\$180,000
Program A	80,000
Program B	40,000
Management and general	10,000
Total	<u>\$310,000</u>

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of \$310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	<u>Direct Mail</u>	<u>Special Events</u>	<u>Telethon</u>	<u>Total</u>
Fund raising	\$40,000	\$50,000	\$90,000	\$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	<u>\$50,000</u>	<u>\$150,000</u>	<u>\$110,000</u>	<u>\$310,000</u>

[Note to reader: Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity (\$50,000, \$150,000, and \$110,000) is encouraged but not required.]

APPENDIX H

Contrast of Guidance in This SOP With the Guidance in SOP 87-2^{14,*}This SOP

Applies to all entities that solicit contributions, including state and local governments.

Covers *all* costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been

SOP 87-2

Applied to entities that follow the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*^{*} or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.)

Covers only joint costs of joint activities.

(continued)

¹⁴ In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the guidance in SOP 87-2 is incorporated into paragraphs 13.36 to 13.45 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

^{*} The AICPA Audit and Accounting Guides *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* were superseded by the 1996 edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. However, because the accounting guidance contained in these Guides remained applicable to certain governmental entities (pursuant to the provisions of GASB Statement Nos. 15, *Governmental College and University Accounting and Financial Reporting Models*, and 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*), the AICPA continued to make these Guides available for sale.

With the recent issuance of GASB Statement Nos. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, which supersede the effect of GASB Statement Nos. 15 and 29, it is no longer necessary for the AICPA to continue selling these Guides.

Accordingly, *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* will no longer be included as part of this loose-leaf publication.

Once the phased-in effective dates of the GASB Statements have occurred, the accounting guidance in these Guides will no longer be applicable to any governmental entities. Please note that the Guides have not been updated since 1994. Therefore, if you already have a Guide, and choose to continue using it until the phase-in period is complete, you must consider guidance issued since they were last updated.

This SOP

incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)

Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.

Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.

Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.

SOP 87-2

Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.

Neither prescribes nor prohibits any allocation methods. No illustrations are provided.

Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

APPENDIX I

Effects on Other Guidance

I.1. For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.36 to 13.45 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

I.2. Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.22, 13.24, and 13.25 of *Not-for-Profit Organizations* are amended as follows:

13.22 Some organizations conduct joint activities* that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

* See the sections of this Guide that provide guidance concerning accounting for the costs of joint activities.

13.24 For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of \$100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization \$25 and that has a fair value of \$30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (a) \$5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (b) fund-raising costs of \$10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of \$200, program expenses of \$60, management and general expenses of \$20, and fund-raising expenses of \$20.

13.25 Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:	
Contributions	\$200
Special event revenue	100
Less: Costs of direct benefits to donors	<u>(25)</u>
Net revenues from special events	<u>75</u>
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund raising	<u>35</u>
Total other expenses	<u>115</u>
Increase in unrestricted net assets	<u><u>\$160</u></u>

Illustration 2

Changes in unrestricted net assets:	
Revenues:	
Contributions	\$200
Special event revenue	<u>100</u>
Total revenues	300
Expenses:	
Program	60
Costs of direct benefits to donors	25
Management and general	20
Fund raising	<u>35</u>
Total expenses	<u>140</u>
Increase in unrestricted net assets	<u><u>\$160</u></u>

Illustration 3

Changes in unrestricted net asset:	
Contributions	\$270
Dinner sales	30
Less: Costs of direct benefits to donors	<u>(25)</u>
Gross profit on special events	<u>5</u>
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund raising	<u>35</u>
Total other expenses	<u>115</u>
Increase in unrestricted net assets	<u><u>\$160</u></u>

I.3. For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the AICPA Industry Audit

Guide *Audits of Voluntary Health and Welfare Organizations** (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*,* as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*,* as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*,* as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.

* The AICPA Audit and Accounting Guides *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* were superseded by the 1996 edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. However, because the accounting guidance contained in these Guides remained applicable to certain governmental entities (pursuant to the provisions of GASB Statement Nos. 15, *Governmental College and University Accounting and Financial Reporting Models*, and 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*), the AICPA continued to make these Guides available for sale.

With the recent issuance of GASB Statement Nos. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, which supersede the effect of GASB Statement Nos. 15 and 29, it is no longer necessary for the AICPA to continue selling these Guides.

Accordingly, *Audits of Colleges and Universities*, *Audits of Voluntary Health and Welfare Organizations*, and *Audits of Certain Nonprofit Organizations* will no longer be included as part of this loose-leaf publication.

Once the phased-in effective dates of the GASB Statements have occurred, the accounting guidance in these Guides will no longer be applicable to any governmental entities. Please note that the Guides have not been updated since 1994. Therefore, if you already have a Guide, and choose to continue using it until the phase-in period is complete, you must consider guidance issued since they were last updated.

Glossary

Activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

Compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

Contributions. Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of joint activities. Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

Fund-raising activities. Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

Help accomplish the entity's mission. Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

Joint activity. A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

Joint costs. Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

Management and general activities. Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They

include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

Medium. A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

Membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

Program activities. Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

Appendix D

**Statement of
Position**

98-3

**Audits of States,
Local Governments, and
Not-for-Profit Organizations
Receiving Federal Awards**

March 17, 1998

With conforming changes as of May 1, 2002

Includes Guidance on the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 Revision)

Supersedes AICPA Statement of Position 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and Part VII, "Audits of Federal Financial Assistance," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (Non-GASB 34 Edition)

**Issued Under the Authority of
the Auditing Standards Board**

**American Institute of
Certified Public Accountants**

NOTE

This Statement of Position presents the recommendations of the AICPA Single Audit Working Group regarding the performance of audits in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This edition incorporates guidance contained in the 1994 revision to *Government Auditing Standards*, as amended, and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.

Auditing guidance included in an AICPA auditing Statement of Position is an *interpretive publication* pursuant to Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU section 150). Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board. The members of the Auditing Standards Board have found this Statement of Position to be consistent with existing Statements on Auditing Standards.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

This SOP reflects relevant auditing guidance contained in authoritative pronouncements through May 1, 2002, as follows:

- SAS No. 96, *Audit Documentation*
- 1994 revision to *Government Auditing Standards* Amendment No. 3, Independence

Users of this SOP should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this SOP. Users may be able to obtain information about such subsequent pronouncements on the AICPA's Web site at <http://www.aicpa.org> and the GAO's Web site at www.gao.gov/govaud/bk01.htm.

The conforming changes made in the current edition of this SOP are identified in Appendix F. The changes do not include all those that might be considered necessary if the SOP were subjected to a comprehensive review and revision.

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SUMMARY

This Statement of Position (SOP) provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This SOP supersedes SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and part VII, "Audits of Federal Financial Assistance," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*.

In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, this SOP—

- Describes the applicability of the Single Audit Act Amendments of 1996 and Circular A-133.
- Describes the auditor's responsibility for testing and reporting on the schedule of expenditures of federal awards.
- Describes the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements under generally accepted auditing standards, *Government Auditing Standards*, and Circular A-133.
- Describes the auditor's responsibility for reporting and provides examples of the reports required by *Government Auditing Standards* and Circular A-133.
- Describes the auditor's responsibility for testing and reporting in a program-specific audit.

Further, this SOP incorporates guidance from the following documents:

- The Single Audit Act Amendments of 1996 and Circular A-133
- AICPA Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*
- *Government Auditing Standards* (1994 revision as amended)
- The OMB Circular A-133 *Compliance Supplement*

This edition of the SOP includes conforming changes for relevant auditing pronouncements through May 1, 2002, as presented in the earlier Note. For additional information on selected auditing pronouncements, see the AICPA's annual Audit Risk Alert *State and Local Governmental Developments*. The Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* (Guide) contains guidance for planning, performing, evaluating the results of, and reporting on the audits of financial statements issued by state and local governments that have or are required to apply the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. The Guide is effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply the provisions of GASB Statement Nos. 34 or 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. Earlier application of the Guide is encouraged if a government issues financial statements that apply GASB Statement Nos. 34 or 35 after the Guide is issued. The Guide specifies that auditor reporting on the audits of such governmental financial statements should be based on *opinion units*. This SOP discusses audits of governmental financial statements

and the auditor's responsibilities and reporting, and presents an illustrative auditor's report on governmental financial statements as Example 1 in Appendix D. The sections of this SOP that discuss financial statement audits and the illustrative reports have not been revised for the effects of the Guide. Such conforming changes will be made to this SOP in the May 2003 edition.

Chapter 1

INTRODUCTION AND OVERVIEW

Introduction

Purpose and Applicability

1.1 The purpose of this Statement of Position (SOP) is to provide auditors of states, local governments, and not-for-profit organizations (NPOs) that receive federal awards with a basic understanding of the procedures they should perform and of the reports they should issue for single audits and program-specific audits under—

- a. The Single Audit Act Amendments of 1996 (hereinafter referred to as the Single Audit Act or the Act).¹
- b. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*,² and the related *OMB Circular A-133 Compliance Supplement*.
- c. The standards applicable to financial audits contained in the 1994 revision of *Government Auditing Standards*, as amended (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. General Accounting Office (GAO).³ These standards, which are periodically amended and codified, incorporate the fieldwork and reporting standards of generally accepted auditing standards (GAAS)⁴ issued by the American Institute of Certified Public Accountants (AICPA).*

¹ The Single Audit Act Amendments of 1996 (Public Law 104-156) was enacted into law in July 1996 and replaced the Single Audit Act of 1984. A reprint of the Single Audit Act Amendments of 1996 is included in appendix A of this SOP.

² Circular A-133 (as revised on June 30, 1997), is reprinted in appendix B of this SOP.

³ The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

⁴ GAAS requirements are discussed in this SOP to the extent necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to relevant AICPA Statements on Auditing Standards and also related Audit and Accounting Guides such as *Not-for-Profit Organizations*, *Health Care Organizations*, and *Audits of State and Local Governmental Units* for additional information on GAAS requirements.

* In December 2001, the AICPA Auditing Standards Board (ASB) issued SAS No. 95, *Generally Accepted Auditing Standards*. SAS No. 95 supersedes "Generally Accepted Auditing Standards" of SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), to establish a hierarchy of generally accepted auditing standards consisting of auditing standards, interpretive publications, and other auditing publications. Under the provisions of SAS No. 95—

- Auditing standards are the general, field work, and reporting standards approved and adopted by the membership of the AICPA, as amended by the ASB, as well as the Statements on Auditing Standards (SASs). The auditor should have sufficient knowledge of the SASs to identify those that are applicable to his or her audit and be prepared to justify departures from the SASs.
- Interpretive publications consist of auditing interpretations of the SASs, auditing guidance in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position. The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by that auditing guidance.
- Other auditing publications include, AICPA auditing publications not referred to above. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

SAS No. 95 is effective for audits of financial statements for periods beginning on or after December 15, 2001.

1.2 This SOP provides guidance about financial and compliance auditing standards and requirements related to single audits (chapters 1 through 10) and program-specific audits (chapter 11) for entities (also referred to as auditees) subject to the Single Audit Act and Circular A-133.* Applicable standards and requirements are promulgated by the OMB, GAO, and AICPA. This SOP also provides guidance on applicable auditing standards and requirements established by those organizations to assist auditors in planning, performing, and reporting on single audits and program-specific audits in accordance with those standards and requirements, and includes illustrative audit reports. Since Circular A-133 is the federal policy guidance to which auditors are held in performing single audits, this SOP will primarily focus on its requirements.

1.3 This SOP is organized by chapters in which the important considerations in performing single audits and program-specific audits are discussed (see table of contents).

1.4 This SOP is not a complete manual of procedures, nor should it supplant the auditor's judgment about the audit work required in particular situations. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures included in this SOP cannot cover all the circumstances or conditions that would be encountered in the audits of every entity. The auditor should use professional judgment to tailor his or her procedures to meet the conditions of the particular engagement, so that the audit objectives may be achieved.

1.5 Auditors should be aware that certain states have imposed additional audit requirements related to state or local financial assistance. The guidance in this SOP does not extend to individual state requirements (except for the guidance in paragraphs 3.49, 3.50, and 6.71). Furthermore, pass-through entities may impose additional audit requirements on their subrecipients related to the financial assistance passed through. The guidance in this SOP also does not extend to those requirements.

Definitions

1.6 The terms used in this SOP are intended to be consistent with the definitions in the Single Audit Act and Circular A-133. Similarly, the term *not-for-profit organization* as used in this SOP is consistent with the definition of the term *non-profit organization* in Circular A-133 (see appendix B) and includes not-for-profit institutions of higher education, hospitals, and other health care providers.

Effective Dates

1.7 The requirements of the Single Audit Act and Circular A-133 are effective for audits of fiscal years beginning after June 30, 1996. This SOP also includes relevant auditing guidance through AICPA Statement on Auditing Standards (SAS) No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). The effective dates of this auditing guidance should be applied as provided for in the related literature. This SOP does not change the effective dates of the auditing standards, the act, and Circular A-133. The

* The AICPA has also issued a Circular A-133 practice aid titled *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133*, which is periodically updated for any needed conforming changes. The practice aid contains comprehensive analyses of, as well as guidance on applying, Circular A-133, numerous audit checklists, illustrative examples, and case studies. An illustrative engagement letter and representation letter are also included. To order the latest version of the practice aid, contact the AICPA Order Department at 1-888-777-7077.

remaining provisions of this SOP are applicable to audits of fiscal years beginning after June 30, 1996, in which the related fieldwork commences on or after March 1, 1998. Earlier application is encouraged.

Objectives of a Single Audit

1.8 A single audit has two main objectives: (a) an audit of the entity's financial statements and the reporting on the schedule of expenditures of federal awards in relation to those financial statements and (b) a compliance audit of federal awards expended during the fiscal year. Each of these results in the preparation and issuance of certain audit reports (see paragraph 2.7 for a more detailed description of the audit objectives).

Audit of Entity's Financial Statements and Reporting on the Schedule of Expenditures of Federal Awards

1.9 The financial statement audit required by Circular A-133 is performed in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* and GAAS, and it results in the auditor reporting on the entity's financial statements and on the scope of the auditor's testing of compliance and internal control over financial reporting and presents the results of those tests. The primary sources of guidance and standards regarding financial statement audits are the AICPA Statements on Auditing Standards (SASs), particularly SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801); *Government Auditing Standards*; and the following AICPA Audit and Accounting Guides, as applicable: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and *Health Care Organizations*.^[5] * Refer to chapter 4 for a more detailed discussion of financial statement audit considerations under Circular A-133. Guidance on reporting on the schedule of expenditures of federal awards is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Refer to chapter 5 for a more detailed discussion of the schedule of expenditures of federal awards.

Compliance Audit of Federal Awards

1.10 Under Circular A-133, the auditor has additional testing and reporting responsibilities for compliance, as well as internal control over compliance, beyond a financial statement audit performed in accordance with *Government Auditing Standards* and GAAS. The compliance audit of federal awards expended during the fiscal year provides a basis for issuing an additional report on compliance related to major programs and on internal control over compliance.⁶ The various types of federal awards and payment methods are described in paragraphs 1.17 through 1.23. Compliance auditing considerations applicable to major programs and internal control over compliance are discussed in chapters 6 and 8. Reporting is discussed in chapter 10.

Adherence to Professional Standards and Requirements

1.11 The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements*

^[5] [Deleted.]

* See footnote * to paragraph 1.1.

⁶ A major program is defined in Circular A-133. See the discussion of the determination of major programs in chapter 7.

in *Governmental Audits*, states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession and a violation of rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons for doing so are given.

Relationship of the Single Audit Act, Circular A-133, Government Auditing Standards, and GAAS

1.12 The Single Audit Act Amendments of 1996 were enacted to streamline and improve the effectiveness of audits of federal awards and to reduce the audit burden on states, local governments, and NPOs. Those goals were achieved, in part, by increasing the dollar threshold for requiring a single audit or program-specific audit to \$300,000 in federal awards expended from \$25,000 in federal awards received and introducing a risk-based approach for determining which federal programs are to be considered major programs (see paragraph 2.2 for a further discussion of the audit threshold). The Single Audit Act requires single audits and program-specific audits of federal awards to be performed in accordance with *Government Auditing Standards*,⁷ and gives the Director of OMB the authority to develop government-wide guidelines and policy on performing audits to comply with the Act. The OMB established audit guidelines and policy in Circular A-133, which was revised and issued June 30, 1997,⁸ and establishes a uniform system of auditing states, local governments, and NPOs that expend federal awards. (Chapter 2 provides an overview of Single Audit Act and Circular A-133 requirements.) Circular A-133 has been adopted in regulation by individual federal departments and agencies.

1.13 In performing audits in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*, the auditor assumes certain responsibilities beyond those of audits performed in accordance with GAAS.⁹ *Government Auditing Standards* includes general standards, incorporates the fieldwork and reporting standards under GAAS, and

⁷ *Government Auditing Standards* includes standards for financial audits as well as for performance audits. The references to *Government Auditing Standards* in this SOP encompass only the standards applicable to financial audits and not the performance audit standards (see footnote 3). However, *Government Auditing Standards* states that auditors should follow, as appropriate, the report contents standards for objectives, scope, and methodology; audit results; the view of responsible officials; and its report presentation standards. A discussion of these standards is contained in the performance auditing standards in chapter 7 of *Government Auditing Standards* (see paragraph 10.21).

⁸ The June 30, 1997, revision to Circular A-133 superseded OMB Circular A-128, *Audits of State and Local Governments*, and all previous versions of Circular A-133.

⁹ Paragraphs 21 through 23 of SAS No. 74 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 74 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone may not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, if the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions in relation to the guidance in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol.1, AU sec. 317), and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol.1, AU sec. 316).

includes additional fieldwork and reporting standards. *Government Auditing Standards* includes additional standards in such areas as quality control reviews, continuing professional education, documentation requirements, auditor communication, working papers, and audit follow-up (see paragraphs 3.8 through 3.23 for a detailed discussion of the additional standards).^{*} The reporting responsibilities in *Government Auditing Standards* require additional reporting on compliance and on internal control over financial reporting (see paragraphs 3.23, 10.15, and 10.16 for a detailed discussion of the reporting requirements).

Compliance Testing

1.14 Table 1.1 presents the relationship among the compliance testing requirements of GAAS, *Government Auditing Standards*, the Single Audit Act, and Circular A-133. Compliance testing requirements are discussed in detail in chapter 6. SAS No. 74 provides general guidance on the auditor's responsibility for compliance auditing under GAAS, *Government Auditing Standards*, and federal audit requirements. In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit is described. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors.

Internal Control Consideration

1.15 Table 1.2 presents the relationship among the requirements to consider internal control under GAAS, *Government Auditing Standards*, the Single Audit Act, and Circular A-133. Internal control requirements are discussed in detail in chapters 4 and 8.

^{*} In January 2002, the U.S. General Accounting Office issued Amendment No. 3 to *Government Auditing Standards* titled *Independence*. It is effective for audits of periods beginning on or after October 1, 2002, with early implementation encouraged. Amendment No. 3 includes additional standards in the area of independence. See footnote * to paragraph 3.8 for additional information on Amendment No. 3.

Table 1.1

Compliance Testing

	Fieldwork Responsibilities	Reporting Responsibilities
Generally accepted auditing standards	Design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 54, <i>Illegal Acts by Clients</i> , as described in SAS No. 74, <i>Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance</i> , and to provide reasonable assurance about whether the financial statements are free of material misstatements (whether caused by error or fraud), as described in SAS No. 82, <i>Consideration of Fraud in a Financial Statement Audit</i> , and SAS No. 47, <i>Audit Risk and Materiality in Conducting an Audit</i> .	Requires the auditor to adequately inform the audit committee or others with equivalent authority and responsibility about any illegal acts that the auditor becomes aware of during the audit unless they are clearly inconsequential. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. When the auditor identifies fraud risk factors that have continuing control implications, the auditor should communicate those factors that are considered reportable conditions to senior management and the audit committee. See SAS No. 82, paragraphs 38 through 40, for an additional discussion of the reporting requirements of SAS No. 82.
Government Auditing Standards	Same responsibilities as required by GAAS, but <i>Government Auditing Standards</i> specifically states that auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. <i>Government Auditing Standards</i> also requires auditors to communicate information to certain parties during the planning stages of an audit regarding the nature and extent of planned testing and reporting on compliance with laws and regulations.	Requires a written report describing the scope of the auditor's testing of compliance with laws and regulations and presenting the results of those tests (additional details on the reporting responsibilities are included in paragraphs 10.15, 10.16, and 10.21 through 10.25).

(continued)

	<i>Fieldwork Responsibilities</i>	<i>Reporting Responsibilities</i>
Single Audit Act and Circular A-133	Determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that have a direct and material effect on each major program.	Requires the auditor to express an opinion on whether the entity complied with laws, regulations, and with the provisions of contracts or grant agreements which could have a direct and material effect on each major program and, where applicable, refer to a separate schedule of findings and questioned costs.

Table 1.2

Internal Control Responsibilities

	Fieldwork Responsibilities	Reporting Responsibilities
Generally accepted auditing standards	Obtain an understanding of internal control over financial reporting sufficient to plan the audit by performing procedures to understand both the design of controls relevant to an audit of financial statements and whether they have been placed in operation, and assess control risk, in accordance with SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> , as amended by SAS No. 78, <i>Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55</i> , and SAS No. 94, <i>The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit</i> .	Requires the auditor to communicate, either orally or in writing, any reportable conditions as described in SAS No. 60, <i>Communication of Internal Control Related Matters Noted in an Audit</i> .
Government Auditing Standards	Same responsibilities as GAAS except that <i>Government Auditing Standards</i> requires additional documentation requirements when assessing control risk at maximum for controls significantly dependent upon computerized information. <i>Government Auditing Standards</i> also requires auditors to communicate information to certain parties during the planning stages of an audit regarding the nature and extent of planned testing and reporting on internal control over financial reporting. <i>Government Auditing Standards</i> also provides additional guidance on safeguarding of assets and control over compliance with laws and regulations.	Requires a written report describing the scope of the auditor's testing of internal control and presenting the results of those tests. Also requires separate identification and written communication of all reportable conditions, including those reportable conditions that are individually or cumulatively material weaknesses.
Single Audit Act and Circular A-133	With regard to internal control over compliance, the auditor is required to do the following (in addition to the requirements of <i>Government Auditing Standards</i>): (1) perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, (2) plan the testing of internal control over major programs to	Requires a written report on internal control over major programs describing the scope of testing internal control and the results of the tests, and, where applicable, referring to a separate schedule of findings and questioned costs.

(continued)

*Fieldwork
Responsibilities**Reporting
Responsibilities*

support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program, and (3) perform tests of internal control (unless the internal control is likely to be ineffective in preventing or detecting noncompliance).

* Circular A-133 requires the auditor to plan the audit to support a low assessed level of control risk for major programs; however, it does not actually require the achievement of a low assessed level of control risk. See paragraphs 8.16 through 8.22.

Reporting

1.16 A matrix depicting the recommended auditor’s reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133 appears in table 1.3. Reporting is discussed in detail in chapter 10.

Table 1.3

Report	Recommended Reporting in Single Audits		
	Required by—		
	GAAS	Government Auditing Standards	Circular A-133
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Types of Federal Awards and Payment Methods

Definition of Federal Awards

1.17 Circular A-133 defines federal awards as *federal financial assistance* and *federal cost-reimbursement contracts* that auditees receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts (under grants or contracts) used to buy goods or services from vendors. See paragraph 2.15 for a discussion of subrecipient and vendor determinations.

Federal Financial Assistance—Classification and Types

1.18 Federal sponsors have classified federal financial assistance into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. Circular A-133 defines federal programs as all federal awards under the same CFDA number. Certain clusters of federal programs should be treated as one program for determining major programs. Research and development, student financial aid, and certain other programs are defined as a cluster in the *OMB Circular A-133 Compliance Supplement* because they are closely related and share common compliance requirements (see paragraphs 1.26 through 1.28 and chapters 2 and 6 for additional discussion of the *Compliance Supplement*).

1.19 Sometimes state governments combine funding from different federal awards in providing assistance to their subrecipients when the awards are

closely related programs and share common compliance requirements. In this case, Circular A-133 states that the state may require the subrecipient to treat the combined federal awards as a cluster of programs. See paragraph 2.18 for further information.

1.20 There are over 1,000 individual grant programs and several distinct types of federal award payment methods. Many of these programs are described in the CFDA; however, certain programs may not be included. For example, contracts may not be listed in the CFDA. Circular A-133 states that when a CFDA number is not assigned, all federal awards from the same agency that are made for the same purpose should be combined and considered one program.

1.21 Programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through seven financial and eight nonfinancial types of assistance. The following list describes the eight principal types of assistance that are available.

- *Formula grants.* For activities of a continuing nature not confined to a specific project, allocations of money to nonfederal entities are made in accordance with a distribution formula prescribed by law or administrative regulation. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services. Another example is the Department of Justice's award to state and local governments for drug control and systems improvement.
- *Project grants.* These involve the funding (for fixed or known periods) of specific projects, or the delivery of specific services or products, without liability for damages resulting from a failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, construction grants, and unsolicited contractual agreements.
- *Direct payments for specific use.* Financial assistance is provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon the recipient's performance. These do not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance is provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance is provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed insured loans.* For these programs, the federal government makes an arrangement to indemnify a lender against part of any defaults by those responsible for the repayment of loans.
- *Insurance.* Financial assistance is provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.
- *Sale, exchange, or donation of property and goods.* These programs provide for the sale, exchange, or donation of federal real property,

personal property, commodities, and other goods, including land, buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

Federal Cost-Reimbursement Contracts

1.22 The definition of federal awards also includes federal cost-reimbursement contracts. These are contracts with nonfederal entities to provide goods or services to the federal government. These contracts are generally governed by the Federal Acquisition Regulations (found in part 41 of the *Code of Federal Regulations*) and the terms of the contracts.

1.23 Awards may be provided to entities through reimbursement arrangements in which recipients bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit entities to draw cash as grant expenditures are incurred.

Determining the Scope of a Single Audit

1.24 The scope of the auditor's work in an audit in accordance with Circular A-133 is determined by (a) the level of assessed risk associated with the federal programs and whether they are identified as a major program and (b) the compliance requirements applicable to those programs.

Risk-Based Approach

1.25 The audit scope depends on whether the federal awards expended are identified as relating to major programs. Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides criteria for the auditor to use in applying a risk-based approach. The auditor's determination of the programs to be audited is based on an overall evaluation of the risk of noncompliance occurring which could be material to the individual federal programs. In evaluating risk, the auditor considers, among other things, the current and prior audit experience with the auditee, oversight by the federal agencies and pass-through entities, and the inherent risk of the federal programs. Chapter 7 includes a detailed discussion of applying the risk-based approach to determining major programs.

Compliance Requirements

1.26 Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The term *compliance requirements* refers to the laws, regulations, and provisions of contracts and grant agreements that an auditor should consider in making this determination (see chapter 6 for a more detailed discussion).

1.27 The principal compliance requirements and suggested audit procedures for the largest federal programs are included in the *Compliance Supplement*.¹⁰

1.28 With regard to federal programs included in the *Compliance Supplement*, the auditor should follow the guidance contained in the *Compliance Supplement* for testing compliance requirements. The auditor should be aware

¹⁰ The Compliance Supplement is updated on an annual basis. A copy of the most current version of the Compliance Supplement is available for sale from the Government Printing Office by calling (202) 512-1800. It is also available from the OMB's home page at <http://www.white-house.gov/omb/grants/>.

that compliance requirements may change over time. Thus, the auditor should also inquire of the auditee and review the provisions of grant agreements to determine whether compliance requirements reflected in the *Compliance Supplement* have changed. If there have been changes, the auditor should follow the provisions of the *Compliance Supplement* as modified by the changes (see chapters 2 and 6 for a more detailed discussion of the *Compliance Supplement*). For programs not listed in the *Compliance Supplement*, the auditor should follow *Compliance Supplement* part 7 “Guidance for Auditing Programs Not Included in This Compliance Supplement,” which instructs the auditor to use the types of compliance requirements (for example, cash management, reporting, allowable costs/cost principles, activities allowed or unallowed, eligibility, and matching, level of effort, and earmarking) contained in the *Compliance Supplement* as guidance for identifying the types of compliance requirements to test, and to determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

1.29 In addition, some agencies have developed audit guides or supplements related to their programs. Auditors should consult with the applicable federal agency to determine the availability of agency-prepared supplements or audit guides. This guidance, where applicable, may be obtained from the Office of Inspector General of the appropriate federal agency.

The Auditor’s Responsibilities in Single Audits— An Overview

Compliance With Laws and Regulations

1.30 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to provide an opinion on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The auditor’s responsibility for compliance auditing is discussed further in chapter 6. The required reporting and the schedule of findings and questioned costs are discussed in chapter 10.

Internal Control Over Compliance

Planning

1.31 In a single audit, the auditor must obtain an understanding of the design and operation of internal control over compliance with requirements that could have a direct and material effect on a major program. The auditor’s work in this area is in addition to the consideration of internal control over financial reporting that is part of a financial statement audit. Specifically, the auditor must obtain an understanding of internal control over compliance that is sufficient to plan the audit to support a low assessed level of control risk for major programs.

Testing

1.32 Circular A-133 also requires auditors to test internal control over compliance by implementing the planned tests. Evidence gained from the tests

of controls relevant to compliance requirements may be used by the auditor to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements applicable to major programs. The requirements and auditor responsibilities associated with internal control over compliance in a single audit are discussed in chapter 8.

Chapter 2

OVERVIEW OF THE SINGLE AUDIT ACT, CIRCULAR A-133, AND THE OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT

2.1 This chapter provides an overview of the significant requirements and guidance in the Single Audit Act, Circular A-133, and the *OMB Circular A-133 Compliance Supplement*. Because Circular A-133 incorporates the requirements of the Single Audit Act and provides additional guidance, the requirements of the Act and Circular A-133 are discussed together as one in this SOP. Accordingly, references to Circular A-133 also include the requirements of the Single Audit Act. Auditors should refer to the Single Audit Act, Circular A-133, and the *Compliance Supplement* for a complete understanding of the requirements. The Single Audit Act and Circular A-133 are reprinted in appendixes A and B, respectively. See footnote 10 of chapter 1 for instructions on how to obtain a copy of the *Compliance Supplement*.

Single Audit Act and Circular A-133 Requirements

General Audit Requirements

Audit Threshold

2.2 Entities that expend \$300,000 or more in a fiscal year in federal awards are subject to the Single Audit Act and Circular A-133 and, therefore, must have a single or program-specific audit. Entities expending awards under only one program (excluding research and development [R&D]) may elect to have a program-specific audit if the program's laws, regulations, or grant agreements do not require a financial statement audit. A program-specific audit may not be elected for R&D unless (a) all expenditures are for awards received from the same federal agency or from the same federal agency and the same pass-through entity and (b) advance approval is obtained (see chapter 11 for additional guidance on program-specific audits). Entities that expend less than \$300,000 in a fiscal year in federal awards are exempt from audit requirements in the Single Audit Act and Circular A-133. However, those entities are not exempt from other federal requirements (including those to maintain records) concerning federal awards provided to the entity. Such records must be available for review or audit by appropriate officials of a federal agency, pass-through entity, and the GAO. The Single Audit Act provides that, every two years, the OMB may review the amount for requiring audits and may raise the dollar threshold amount above \$300,000.

Applicable Standards and Covered Entity

2.3 Circular A-133 audits must be conducted by an independent auditor* in accordance with *Government Auditing Standards*, and they must cover the entire operations of the auditee or, at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards during

* The Single Audit Act defines "independent auditor" as (a) an external state or local government auditor who meets the independence standards included in *Government Auditing Standards* or (b) a public accountant who meets such independence standards. In January 2002, the U.S. General Accounting Office issued Amendment No. 3 to *Government Auditing Standards* titled *Independence*. Amendment No. 3 is effective for audits of periods beginning on or after October 1, 2002, with early implementation encouraged. See footnote * to paragraph 3.8 for additional information on Amendment No. 3.

the fiscal year, provided that each audit encompasses the financial statements and the schedule of expenditures of federal awards for each such department, agency, and organizational unit (see paragraph 3.27 for a more detailed discussion of this requirement).

Relation to Other Audit Requirements

2.4 A Circular A-133 audit is deemed to be in lieu of any financial audit of federal awards that an entity is required to undergo under any other federal law or regulation. However, notwithstanding a Circular A-133 audit, a federal agency (including its Inspectors General or GAO) may conduct or arrange for additional audits (for example, financial audits, performance audits, evaluations, inspections, or reviews) that are necessary to carry out their responsibilities under federal law or regulation. Any additional audits should be planned and performed in such a way as to build upon work performed by auditors. A federal agency that conducts or contracts for additional audits must arrange for funding the full cost of such additional audits. See paragraph 2.19 for a discussion of the federal agency option to request certain programs to be audited as major programs.

Frequency of Audits

2.5 Circular A-133 audits must be performed annually unless an auditee meets one of the following criteria that would allow it to have biennial audits (biennial audits should cover both years within the biennial period):

- State or local governments that are required by constitution or statute (in effect on January 1, 1987) to undergo audits less frequently than annually are permitted to have Circular A-133 audits performed biennially. This requirement must still be in effect for the biennial period under audit.
- NPOs that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, are permitted to have Circular A-133 audits performed biennially.

Non-U.S.-Based Entities

2.6 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient. For example, if a federal agency provides financial assistance to an orphanage operated by a foreign government, Circular A-133 would not apply. However, the circular does apply to expenditures made by U.S.-based entities outside of the United States and by foreign branches of U.S.-based entities. For example, if a university based in the United States receives a federal award for travel and a three-month residence in a foreign country to conduct research, Circular A-133 would apply to the travel and the related research costs incurred in the foreign country. Another example would be a hospital that receives a federal award to perform medical research in a foreign country. If the research is conducted in the hospital's research laboratory based in the foreign country, the federal award would be subject to an audit under Circular A-133.

Audit Objectives and Reporting Matters

Audit Objectives

2.7 In a single audit, the auditor's objectives are to—

- Determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. (Note that Circular A-133 does not

prescribe the basis of accounting that must be used by auditees to prepare their financial statements. See paragraphs 4.2 and 4.3 for a further discussion.)

- Determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.
- Obtain an understanding of the internal control over compliance for each major program, assess the control risk, and perform tests of those controls unless the controls are deemed to be ineffective (the auditor must perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for each major program).
- Determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that may have a direct and material effect on each of its major programs.

Audit Reports

2.8 Section 505 of Circular A-133 includes specific auditor reporting requirements. Those requirements are summarized in paragraph 10.3. See paragraphs 10.8 through 10.10 for a description of the reports illustrated in this SOP to meet the reporting requirements of Circular A-133.

Timing of the Submission of the Report

2.9 The audit should be completed and the data collection form and the reporting package (described in paragraphs 2.24, 2.25, 10.6, and 10.7), including the auditor's reports, should be submitted by the auditee (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit (see paragraphs 10.74 through 10.79 for a further discussion).^[2]

Audit Follow-Up

2.10 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 3.26 and 6.61 through 6.67 for a further discussion of the auditor's responsibility for audit follow-up.)

Auditor Selection and Audit Costs

Procurement of Audit Services and Restriction on Auditors Who Prepare Indirect Cost Proposals

2.11 Circular A-133 also establishes guidance on the procurement of audit services, as well as guidance on the restrictions on the selection of auditors who also prepare the indirect cost proposal or cost allocation plan.

^[2] [Deleted.]

Auditors who prepare the indirect cost proposal or cost allocation plan may not also be selected to perform the Circular A-133 audit if the indirect costs recovered by the auditee during the prior year exceeded \$1 million.^[3] * See paragraph 3.54 for additional information on this restriction.

Audit Costs

2.12 Circular A-133 provides guidance on whether the charging of audit costs to federal awards may be allowed. Unless prohibited by law, the costs of Circular A-133 audits are allowable charges to federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB Cost Principles Circulars, the Federal Acquisition Regulation, or other applicable cost principles or regulations. The costs of single audits that are not conducted in accordance with Circular A-133 are unallowable. Furthermore, audit costs associated with Circular A-133 audits of entities that expend less than \$300,000 per year in federal awards are unallowable. However, this provision does not prohibit pass-through entities from charging federal awards for the costs of limited-scope audits to monitor its subrecipients. See paragraph 9.32 for further information on the allowability of audit costs associated with limited-scope audits. With regard to the amount of audit cost that can be charged to a federal award, the Single Audit Act states that in the absence of documentation demonstrating a higher actual cost, the percentage of the cost of single audits charged to federal awards by an entity may not exceed the ratio of total federal awards expended to the entity's total expenditures for the fiscal year.

Basis for Determining When Federal Awards Are Expended

2.13 The determination of when an award is expended is based on when the activity related to the award occurs. In general, the activity pertains to events that require the auditee to comply with laws, regulations, and the provisions of contracts or grant agreements. Such events include the following:

- Expenditure/expense transactions associated with grants, cost reimbursement contracts, cooperative agreements, and direct appropriations
- The disbursement of funds passed through to subrecipients
- The use of loan proceeds under loan and loan-guarantee programs
- The receipt of property
- The receipt of surplus property
- The receipt or use of program income
- The distribution or consumption of food commodities
- The disbursement of amounts entitling the auditee to an interest subsidy
- The period when insurance is in force

^[3] [Deleted.]

* In January 2002, the U.S. General Accounting Office issued Amendment No. 3 to *Government Auditing Standards* titled *Independence*. It is effective for audits of periods beginning on or after October 1, 2002, with early implementation encouraged. See footnote * to paragraph 3.8 for additional information on Amendment No. 3. Paragraph 3.26(d) of Amendment No. 3 addresses the effect that the preparation of an entity's indirect cost proposal or cost allocation plan has on an auditor's independence. However, even if the auditor's preparation of an indirect cost proposal or cost allocation plan does not impair the auditor's independence, Circular A-133 continues to prohibit an auditor who prepared that proposal or plan from performing the Circular A-133 audit when indirect costs recovered by the entity during the prior year exceeded \$1 million.

2.14 Circular A-133 provides specific guidance on the basis of determining federal awards expended for the following noncash items (see paragraphs 5.13 through 5.15 for additional discussion):

- Loans and loan guarantees, including those at institutions of higher education
- Prior loans and loan guarantees
- Endowment funds
- Free rent
- Noncash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property
- Medicare payments to a nonfederal entity for providing patient care services
- Medicaid payments to a subrecipient for providing patient care services

Subrecipient and Vendor Determinations

2.15 An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient are subject to audit under Circular A-133. The payments received for goods or services provided as a vendor would not be considered federal awards. Circular A-133 provides specific guidance on determining whether payments constitute a federal award or a payment for goods and services. This guidance is discussed further in chapter 9.

Major Program Determination

Risk-Based Approach

2.16 Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. The risk-based approach includes consideration of current and prior audit experience, oversight by federal agencies and pass-through entities, and the inherent risk of the federal programs. This risk-based approach and the determination of major programs are discussed in chapter 7.

Low-Risk Auditee

2.17 Circular A-133 contains certain criteria for considering an auditee to be a low-risk auditee. A low risk-auditee is eligible for reduced audit coverage. It should be noted that *low-risk auditee* is a term defined in Circular A-133 for the purpose of applying the percentage-of-coverage rule (see paragraphs 7.24 and 7.25) in the risk-based approach. It does not imply or require the auditor to assess audit risk or any of its components as low for an entity that meets the Circular A-133 definition of a low-risk auditee.

Cluster of Programs

2.18 OMB Circular A-133 defines a cluster of programs as a grouping of closely related federal programs that share common compliance requirements. The types of clusters of programs are R&D, student financial aid (SFA), and other clusters. "Other clusters" are defined by the OMB in the *Compliance Supplement* or are designated as such by a state for the federal awards the state provides to its subrecipients that meet the definition of a cluster of programs. When a state designates federal awards as an "other cluster," it must also identify the federal awards included in the cluster and advise the subrecipients of the compliance requirements applicable to the cluster. A cluster of programs should be considered as one program for determining major programs and (with the exception of R&D), whether a program-specific audit may be elected.

Federal Agency Selection of Additional Major Programs

2.19 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. After consultation with its auditor, the auditee should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach (described in chapter 7) and, if not, the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon the federal agency request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Auditee Responsibilities

Preparation of Appropriate Financial Statements

2.20 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, the results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with Circular A-133 and prepare separate financial statements (see paragraph 3.27 for a further discussion). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

Summary Schedule of Prior Audit Findings

2.21 The auditee is also required to prepare a summary schedule of prior audit findings. The schedule should report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It should also include audit findings reported in the prior audit's summary schedule of prior audit findings, except audit findings that have been corrected or are no longer valid. See paragraphs 10.68 through 10.70 for a further discussion of this schedule.

Other Responsibilities

2.22 In addition to the responsibilities described in paragraphs 2.20 and 2.21, Circular A-133 establishes certain other responsibilities for auditees, including the following:

- Identifying in its accounts all federal awards received and expended and the federal programs under which they were received, including, as applicable, the CFDA title and number, the award number and year, the name of the federal agency, and the name of the pass-through entity
- Establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the

auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs

- Complying with laws, regulations, and the provisions of contract or grants agreements related to each of its federal programs
- Ensuring that the audits required by Circular A-133 are properly performed and submitted when due
- Following up and taking corrective action on audit findings (including the preparation of a summary schedule of prior audit findings (see paragraph 2.21) and a corrective action plan (see paragraph 2.26); corrective action should be initiated within six months after the receipt of the audit report and proceed as rapidly as possible

Responsibility for Compliance at the Financial Statement Level and for Internal Control Over Financial Reporting

2.23 Although not specifically stated in Circular A-133, the auditee is also responsible for complying with the requirements of laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on the financial statements and for establishing and maintaining effective internal control over financial reporting. These responsibilities support the requirements of *Government Auditing Standards*.

Reporting Package

2.24 The auditee is also required to submit a reporting package that includes financial statements and a schedule of expenditures of federal awards (see paragraph 2.20 and chapters 4 and 5), the summary schedule of prior audit findings (see paragraph 2.21), the auditor's reports (see paragraph 2.8), and a corrective action plan (see paragraph 2.26). Although not part of the reporting package, the submission of the report must also include the data collection form described in paragraph 2.25. The report submission requirements of Circular A-133 are described in paragraphs 2.9 and 10.74 through 10.79. Auditees must keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse. Furthermore, unless restricted by law or regulation, the auditee is required to make copies of the data collection form and the reporting package available for public inspection.

Data Collection Form

2.25 The auditee is required to complete and sign certain sections of a data collection form which states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. The auditor is also required to complete and sign certain sections of this form. See paragraphs 10.71 through 10.73 for a further discussion of the data collection form.

Corrective Action Plan

2.26 At the completion of the audit, the auditee should prepare a corrective action plan to address each audit finding included in the current year's auditor's reports. See paragraphs 10.68 through 10.70 for a further discussion of the corrective action plan.

Federal Awarding Agency Responsibilities

2.27 For federal agencies that provide federal awards to recipients, Circular A-133 establishes certain responsibilities including the following:

- Identifying the federal awards made by informing each recipient of the CFDA title and number, the award name and number, the award year, and if the award is for R&D. When some of this information is not available, the federal agency must provide information necessary to clearly describe the federal award
- Advising recipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements
- Ensuring that audits are completed and reports are received in a timely manner and in accordance with the requirements of Circular A-133
- Providing technical advice and counsel to auditees and auditors as requested
- Issuing a management decision on audit findings within six months after receipt of the audit report and ensuring that the recipient takes appropriate and timely corrective action
- Assigning a person to provide annual updates of the *Compliance Supplement* to the OMB

Pass-Through Entity Responsibilities

2.28 Pass-through entities have many responsibilities that are similar to those of federal awarding agencies. See chapter 9 for a detailed description of the responsibilities of pass-through entities.

Cognizant Agency for Audit

Definition

2.29 Circular A-133 defines the cognizant agency for audit as a federal agency designated to carry out the federal responsibilities with regard to a single audit. For recipients expending more than \$25 million a year in federal awards, the cognizant agency for audit will be the federal awarding agency that provides the predominant amount of direct funding to the recipient unless the OMB makes a specific cognizant agency for audit assignment. The determination of the predominant amount of direct funding is based on the direct federal awards expended by a recipient during its fiscal year ending in 1995, 2000, 2005, and every fifth year thereafter. For example, the audit cognizance for periods ending in 1997 through 2000 will be determined based on the federal awards expended in 1995.⁴ Audit cognizance can be reassigned if both the old and the new federal agencies notify the auditee (and, if known, the auditor), of the change within thirty days of the reassignment. A recipient may have one federal agency responsible for audit cognizance and another federal agency responsible for the negotiation of indirect costs.

Responsibilities

2.30 Circular A-133 states that a cognizant agency for audit is responsible for—

- Providing technical audit advice and liaison to auditees and auditors.

⁴ It should be noted that for states and local governments that expend more than \$25 million a year in federal awards and have previously assigned cognizant agencies for audit, the requirements in this paragraph are not effective until fiscal years beginning after June 30, 2000.

- Considering auditee requests for extensions to the report submission due date. The cognizant agency for audit may grant extensions for good cause.
- Obtaining or conducting quality control reviews of selected audits made by nonfederal auditors and providing the results, when appropriate, to other interested organizations.
- Promptly informing other affected federal agencies and appropriate federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by *Government Auditing Standards* or laws and regulations.
- Advising the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee should work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit must notify the auditor, the auditee, and the applicable federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repeated substandard performance by auditors will be referred to appropriate state licensing agencies and professional bodies for disciplinary action.
- Coordinating, to the extent practicable, the audits or reviews made by or for federal agencies that are in addition to audits under Circular A-133, so that the additional audits or reviews build upon the Circular A-133 audits performed.
- Coordinating a management decision for audit findings that affect the federal programs of more than one federal agency.
- Coordinating the audit work and reporting responsibilities among auditors, to achieve the most cost-effective audit.

For biennial audits, the cognizant agency for audit is also responsible for considering auditee requests to qualify as a low-risk auditee.

Oversight Agency for Audit

Definition

2.31 An auditee that does not have a designated cognizant agency for audit that (that is, one that expends \$25 million or less in federal awards) will have an oversight agency for audit. Circular A-133 defines the oversight agency for audit as a federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit (see paragraphs 2.29 and 2.30). When there is no direct funding, the federal agency with the predominant indirect funding is required to assume the oversight responsibilities.

Responsibilities

2.32 Circular A-133 describes the duties of oversight agencies for audit. The responsibilities of an oversight agency for audit are not as broad as those of a cognizant agency for audit. However, an oversight agency's primary responsibility is to provide technical advice to auditees and auditors when it is requested. An oversight agency may assume all or some of the responsibilities normally performed by a cognizant agency for audit.

Program-Specific Audits

2.33 Circular A-133 provides general guidance on performing program-specific audits. In many cases, a program-specific audit guide will be available from the federal agency's Office of Inspector General. The audit guide will provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. When a program-specific audit guide is not available, the auditee and auditor have basically the same responsibilities for the federal program as they would have for an audit of a major program in a single audit. Program-specific audits are discussed further in chapter 11.

OMB Circular A-133 Compliance Supplement

2.34 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. The *Compliance Supplement* serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act and Circular A-133. For the programs included in the *Compliance Supplement*, it provides a source of information for auditors to understand the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements. It also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included in the *Compliance Supplement*. For single audits, the *Compliance Supplement* replaces agency audit guides and other audit requirement documents for individual federal programs.

2.35 The *Compliance Supplement*, which is updated on an annual basis, is discussed in greater detail in paragraphs 1.27, 1.28, and 6.21 through 6.30.

Chapter 3

PLANNING AND OTHER SPECIAL AUDIT CONSIDERATIONS OF CIRCULAR A-133

3.1 In planning an audit to meet the requirements of Circular A-133, the auditor needs to consider several matters in addition to those ordinarily associated with an audit of financial statements in accordance with GAAS and *Government Auditing Standards*.¹ In this chapter the overall planning considerations in a single audit conducted in accordance with Circular A-133 are discussed. Many of these planning considerations are also applicable in a program-specific audit. Program-specific audits are discussed in detail in chapter 11.

3.2 The following matters are relevant to the planning of a single audit:

- Satisfying Circular A-133 requirements and other relevant legal, regulatory, or contractual requirements (see paragraphs 3.3 through 3.5)
- Establishing an understanding with the auditee (see paragraphs 3.6 and 3.7)
- Satisfying the additional requirements of *Government Auditing Standards* (see paragraphs 3.8 through 3.23)
- Satisfying the additional requirements of the Single Audit Act and Circular A-133 regarding working papers and audit follow-up (see paragraphs 3.24 through 3.26)
- Defining the entity to be audited (see paragraph 3.27)
- Determining the audit period (see paragraphs 3.28 and 3.29)
- Initial-year audit considerations (see paragraphs 3.30 and 3.31)
- The timing of the completion of the audit and reporting submission deadlines (see paragraph 3.32)
- Determining the major programs to be audited (see paragraph 3.33)
- The preliminary assessment of audit risk (see paragraph 3.34)
- Audit materiality considerations (see paragraphs 3.35 through 3.40)
- Determining compliance requirements (see paragraph 3.41)
- Developing an efficient audit approach (see paragraph 3.42)
- Joint audits and reliance on others (see paragraphs 3.43 through 3.46)
- Existence of internal audit function (see paragraph 3.47)
- Communications with the cognizant agency for audit and others (see paragraph 3.48)
- Understanding the applicable state and local compliance and reporting requirements (see paragraphs 3.49 through 3.51)

¹ In AICPA *Professional Standards*, AU section 311, "Planning and Supervision," the auditor's responsibilities for planning and supervision in an audit of financial statements in accordance with GAAS are described. Paragraphs 4.6 through 4.11 of *Government Auditing Standards* describe its planning requirements.

- Desk reviews and on-site reviews (see paragraphs 3.52 and 3.53)
- The restriction on the auditor's preparation of indirect cost proposals (see paragraph 3.54)
- The exit conference (see paragraphs 3.55 and 3.56)

Satisfying Circular A-133 Requirements and Other Relevant Legal, Regulatory, or Contractual Requirements

3.3 Because of the variety of audit requirements to which entities receiving federal awards are subject, paragraph 21 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21), states that auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. The auditor should consider including a statement about the type of engagement and whether it is intended to meet specific audit requirements in a proposal, in a contract, or in the communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7 for a further discussion of the establishment of an understanding with the auditee).

3.4 Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Paragraph 22 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.22) states that GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.² For example, the auditor will be required to make this communication if he or she is engaged to perform an audit of an entity's financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement, the entity is also required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*
- The Single Audit Act and Circular A-133
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

3.5 Paragraph 23 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.23) states that the required communication may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including their potential effect on the financial statements and on the auditor's report

² For entities that do not have audit committees, "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54, *Illegal Acts by Clients*, and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*.

Establishing an Understanding With the Auditee

3.6 SAS No. 83, *Establishing an Understanding With the Client*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), states that the auditor should establish an understanding with the auditee regarding the services to be performed. Such understanding reduces the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. The auditor should document this understanding in the working papers, preferably through a written communication with the auditee. If the auditor believes an understanding with the client has not been established, he or she should decline to accept the engagement.

3.7 SAS No. 83, as amended, includes a listing of the matters that should generally be included when the auditor establishes an understanding with the auditee regarding an audit of the financial statements. In addition to those matters, the auditor should also consider including the following information in the communication when he or she is engaged to perform a single audit:

- A description of the financial statements and supplemental schedule(s) to be audited
- The reporting period
- The auditing standards and requirements that will be followed (for example, GAAS, *Government Auditing Standards*, and Circular A-133)
- The objective of an audit in accordance with Circular A-133
- A description of the reports the auditor is expected to prepare and issue, including any limitation on their use
- A description of management's responsibility for (a) the financial statements and the schedule of expenditures of federal awards; (b) internal control over financial reporting and internal control over compliance; (c) compliance with laws, regulations, and the provisions of contracts and grant agreements; (d) following up and taking corrective action on audit findings, including the preparation of a summary schedule of prior audit findings and a corrective action plan; and (e) submitting the reporting package
- A statement that management has made the auditor aware of significant vendor relationships where the vendor is responsible for program compliance (so that the auditor can determine if additional procedures on vendor records will be necessary—see paragraphs 9.16 and 9.17)
- A description of the auditor's responsibility in an audit of financial statements and in a compliance audit of major programs under Circular A-133, including the determination of major programs, the consideration of internal control, and reporting responsibilities
- Other communications that may arise from the audit
- A description of the working paper retention requirements
- A statement that the working papers will be made available upon request to appropriate federal agencies and the GAO

- The communication with the organization or entity being audited (the auditee), the individuals contracting for or requesting audit services, and the audit committee required by *Government Auditing Standards* (see paragraphs 3.14 and 3.15 for a further discussion of this requirement)

SAS No. 83, as amended, also states that the establishment of an understanding may be communicated in the form of an engagement letter.

Satisfying the Additional Requirements of *Government Auditing Standards*

3.8 Circular A-133 requires that audits of the financial statements and of the federal awards of the auditee be performed in accordance with *Government Auditing Standards* (see chapter 4 for a further discussion). In an audit in accordance with *Government Auditing Standards*, the auditor has considerations beyond those in a GAAS audit. *Government Auditing Standards* incorporates the fieldwork and reporting standards of GAAS and has general standards (described in chapter 2 of *Government Auditing Standards*) that are similar to those of the AICPA (that is, auditor qualifications, independence, and due professional care).^{*} However, *Government Auditing Standards* also contains additional general, fieldwork, and reporting requirements, which are summarized in Table 3.1 and discussed in detail in the three subsequent sections of this chapter.

Table 3.1

Additional Financial Statement Audit Requirements of *Government Auditing Standards*

General Requirements

- Continuing professional education (CPE) in subjects directly related to the government environment and to government auditing or to the specific or unique environment that the audited entity operates in
- Appropriate internal quality control system and external quality control review every three years

Fieldwork Requirements

- Communication with the organization or entity being audited (the auditee), the individuals contracting for or requesting audit services, and the audit committee
- Audit follow-up requirements on known material findings and recommendations from previous audits
- Plan audit to provide reasonable assurance of detecting misstatements resulting from noncompliance with provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts
- Documentation requirements when assessing control risk at maximum for controls significantly dependent upon computerized information systems
- Additional working paper requirements

Reporting Requirements

- Referring to *Government Auditing Standards* in the auditor's report
- Reporting on compliance with laws and regulations and on internal control over financial reporting
- Consideration of privileged and confidential information
- Report distribution

^{*} Amendment No. 3, *Independence*, revises the independence standards in *Government Auditing Standards* for audits for periods beginning on or after October 1, 2002, with early implementation encouraged. Among its provisions, Amendment No. 3 addresses circumstances under which it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client as well as circumstances under which a governmental audit organization is presumed to be organizationally independent from the audited entity.

3.9 *Government Auditing Standards* also provides additional guidance on audit materiality, on fraud^[3] and illegal acts, and on internal control. Table 3.2 summarizes where this additional guidance is provided in *Government Auditing Standards* and also where it is discussed in this SOP.

Table 3.2

Additional Guidance in Government Auditing Standards		
<i>Area of Additional Guidance</i>	<i>Government Auditing Standards Reference</i>	<i>SOP Reference</i>
Materiality	Paragraphs 4.6.1 and 4.6.2	Paragraph 3.36
Fraud and illegal acts	Paragraphs 4.14 through 4.17	Paragraphs 10.21 through 10.25
Internal controls	Paragraphs 4.21 through 4.30	Paragraphs 4.17 and 4.18

General Requirements

Continuing Professional Education

3.10 *Government Auditing Standards* requires auditors to participate in a program of continuing professional education (CPE) and training. Every two years, all auditors (whether certified or not) performing audits in accordance with *Government Auditing Standards* should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of those hours should be completed in each year of the two-year period. For auditors responsible for planning, directing, or reporting on the audit and for auditors conducting substantial portions of the audit, at least twenty-four hours should be in subjects directly related to the government environment and to government auditing. If the auditee operates in a specific or unique environment, auditors should receive training that is related to that environment. For example, if the auditor performs an audit of a not-for-profit organization, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment. These could include compliance and government-related courses or those broadly related to the type of not-for-profit organization being audited.

3.11 *Interpretation of Continuing Education and Training Requirements*, a detailed interpretation of the foregoing CPE standards, is available from the GAO's home page at <http://www.gao.gov/govaud/ybk01.htm>. Among other things, this interpretation discusses who is subject to the CPE requirements and what programs, activities, and subjects qualify as acceptable CPE. During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirements within two years of the start of the first audit in accordance with *Government Auditing Standards*, and every two years thereafter.

Quality Control

3.12 *Government Auditing Standards* also states that the audit organization should have in place an appropriate internal quality control system and undergo an external quality control review (for example, a peer review). An external quality control review should be conducted at least once every three years by an organization not affiliated with the organization being reviewed.

^[3] [Deleted].

3.13 *Government Auditing Standards* further requires audit organizations seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* to provide their most recent external quality control review report to the party contracting for the audit. Auditors are not required to provide separate letters of comment. Auditors should consider documenting in the working papers the provision of the quality control review report to the party contracting for the audit.

Fieldwork Requirements

Auditor Communication

3.14 *Government Auditing Standards* requires the auditor to communicate the following information to the parties identified in paragraph 3.15 during the planning stages of an audit:

- The auditor's responsibilities in a financial statement audit, including their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting.
- The nature of any additional testing of compliance and internal control required by laws and regulations or otherwise requested, and whether the auditor is planning on providing opinions on compliance with laws and regulations and internal control over financial reporting.

To assist in communicating the limitations of the auditor's responsibilities for compliance and internal control over financial reporting, the auditor may also want to contrast those responsibilities with other financial related audits of compliance and controls. The discussion in paragraphs 4.6.8 and 4.6.9 of *Government Auditing Standards* may be helpful to auditors in explaining their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting. Auditors should use professional judgment in determining the form and content of the communication, although written communication is preferred. An engagement letter may be used to make the communication (see paragraphs 3.6 and 3.7). Auditors should document the communication in the working papers.

3.15 The auditor should communicate the information in paragraph 3.14 to the following:

- Appropriate officials of the organization or entity being audited (the auditee) which would normally include the head of the organization, the audit committee or board of directors or other equivalent oversight body in the absence of an audit committee, and the individual who possesses a sufficient level of authority such as the chief financial officer
- In situations where the auditor is performing the audit under a contract with a party other than the auditee, or pursuant to a third-party request, the auditor should also communicate with the individuals contracting for or requesting the audit services; and
- When the auditor is performing the audit pursuant to a law or regulation, the auditor should communicate with the legislative members or staff who have oversight of the auditee. (This requirement applies only to situations where the law or regulation specifically identifies the entity to be audited. Situations where the financial statement audit mandate applies to entities not specifically identified, such as audits required by the Single Audit Act Amendments of 1996, are excluded.)

Audit Follow-Up

3.16 *Government Auditing Standards* states that the auditee is responsible for resolving audit findings and recommendations. It further requires auditors to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. The purpose of this follow-up is to determine whether the auditee has taken timely and appropriate corrective actions. *Government Auditing Standards* also requires auditors to report the status of uncorrected material findings and recommendations that are from prior audits and that affect the financial statement audit. (See paragraphs 3.26, 6.61 through 6.67, and 10.62 for a further discussion of the auditor's responsibility for audit follow-up under both *Government Auditing Standards* and Circular A-133 and how these responsibilities correlate.)

Responsibilities With Regard to the Provisions of Contracts and Grant Agreements

3.17 Paragraph 4.13 of *Government Auditing Standards* refers to additional responsibilities with regard to detecting material misstatements resulting from noncompliance with the provisions of contract and grant agreements that have a direct and material effect on the determination of financial statement amounts. However, it has generally been interpreted under GAAS that the phrase *laws and regulations* in SAS No. 54 implicitly includes the provisions of contracts and grant agreements. Thus, the auditor's responsibility with regard to detecting material misstatements resulting from noncompliance with the provisions of contracts and grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS.

Internal Control Documentation Requirement

3.18 Paragraphs 4.21.3 and 4.21.4 of *Government Auditing Standards* include an additional internal control standard that requires auditors, when planning the audit, to document the following in the working papers (see also paragraphs 3.20 through 3.22 for a further discussion of the additional *Government Auditing Standards* requirements for working papers):

- The basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems; and
- Consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

3.19 This additional standard does not increase the auditor's responsibility for testing controls. However, it may require additional documentation. If the auditor assesses control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, the auditor should document in the working papers the basis for that conclusion by addressing (1) the ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls. In such circumstances, *Government Auditing Standards* also requires the auditor to document in the working papers the consideration that the planned audit procedures are designed to achieve specific audit objectives and, accordingly, to reduce audit risk to an acceptable level. This documentation should address:

- The rationale for determining the nature, timing, and extent of planned audit procedures;
- The kinds and competence of available evidential matter produced outside a computerized information system; and
- The effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

Working Papers

3.20 SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides guidance on the auditor's preparation and maintenance of working papers.* *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. This additional standard requires working papers to include sufficient documentation of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records. *Government Auditing Standards* also states that auditors should provide for working paper access to other auditors, to facilitate reviews of audit quality and reliance by other auditors on the auditor's work, and should provide for such access in contractual arrangements for *Government Auditing Standards* audits (see paragraphs 3.24 and 3.25 for a discussion of the working paper access and retention requirements under Circular A-133).

3.21 Audits done in accordance with *Government Auditing Standards* are subject to review by other auditors and by oversight officials more frequently than are audits done in accordance with GAAS. Thus, whereas GAAS cites two main purposes of working papers (providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit), working papers serve an additional purpose in audits performed in accordance with *Government Auditing Standards*. Working papers allow for the review of audit quality by providing the reviewer written documentation of the evidence supporting the auditor's significant conclusions and judgments.

3.22 *Government Auditing Standards* specifically states that working papers should contain—

* SAS No. 96, *Audit Documentation*, supersedes SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. Among its provisions, SAS No. 96

- Uses the term *audit documentation* to describe the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in an audit engagement.
- Introduces the concepts that audit documentation should enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained, and that audit documentation should indicate the engagement team member(s) who performed and reviewed the work.
- Lists factors that the auditor should consider in determining the nature and extent of the audit documentation to be prepared for a particular audit area or auditing procedure.
- Requires audit documentation to include abstracts or copies of significant contracts or agreements that were examined and, for tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation, requires audit documentation to include an identification of the items tested.
- Requires documentation of audit findings or issues that in the auditor's judgment are significant, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached. (SAS No. 96 includes a list of types of significant audit findings and issues.)
- Requires the auditor to adopt reasonable procedures to prevent unauthorized access to the audit documentation.

- The objectives, scope, and methodology, including any sampling criteria used.
- Documentation of the work performed to support significant conclusions and judgments, including descriptions of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records.⁴
- Evidence of supervisory reviews of the work performed.

Reporting Requirements

3.23 The additional reporting requirements of *Government Auditing Standards*—referring to *Government Auditing Standards* in the auditor's report, reporting on compliance with laws and regulations and on internal control over financial reporting, consideration of privileged and confidential information, and report distribution—are addressed in paragraphs 10.15 and 10.16.

Satisfying the Additional Requirements of the Single Audit Act and Circular A-133 Regarding Working Papers and Audit Follow-Up

Working Papers

3.24 The Single Audit Act states that upon request by a federal agency or the Comptroller General, any independent auditor conducting a single audit should make the auditor's working papers available to the federal agency or the Comptroller General (a) as part of a quality review, (b) to resolve audit findings, or (c) to carry out oversight responsibilities. It also states that access to the auditor's working papers shall include the right to obtain copies. The Single Audit Act intends that federal agencies be judicious in the exercise of this authority and that the release of the working papers should not compromise the confidentiality of proprietary information. The Single Audit Act also intends that any trade secrets and confidential commercial or financial information obtained from the working papers be treated as confidential under the Freedom of Information Act. Auditors should refer to the guidance in the AICPA Auditing Interpretation titled *Providing Access to or Copies of Audit Documentation to a Regulator* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339), when a regulator requests access to the auditor's working papers pursuant to law, regulation, or audit contract.

3.25 Circular A-133 requires that auditors retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor is required to contact the parties contesting the audit finding for guidance prior to the destruction of the working papers and reports.

⁴ Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. Auditors are not required to include in the working papers copies of documents they examined nor are they required to list detailed information from those documents.

Audit Follow-Up

3.26 In addition to the requirements of *Government Auditing Standards*, Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 6.61 through 6.67 and 10.62 for a further discussion of the responsibility for audit follow-up under both Circular A-133 and *Government Auditing Standards* and how these responsibilities correlate.)

Defining the Entity to Be Audited

3.27 One of the initial tasks during the planning process of a single audit is determining whether management has properly defined the entity to be audited. Circular A-133 requires that single audits must cover the entire operations of the auditee. However, Circular A-133 provides auditees the option to meet the audit requirements of the circular through a series of audits that cover an auditee's departments, agencies, and other organizational units which expended or otherwise administered federal awards during a fiscal year. If an auditee elects this option, then separate financial statements and a schedule of expenditures of federal awards must be prepared for each such department, agency, or other organizational unit. In these circumstances, an auditee's organization-wide financial statements may also include departments, agencies, or other organizational units that have separate audits and prepare separate financial statements. For example, if a local government has its school districts audited separately, it would be acceptable for the local government's financial statements to include the school districts, even though the school districts were not included in the local government's Circular A-133 audit, because a separate Circular A-133 audit was conducted of the school districts. However, if separate financial statements were not prepared for the school districts, it would be unacceptable for a separate Circular A-133 audit to be conducted of the school districts (that is, the local government's organization-wide financial statements could not be used as a substitute for separate financial statements for the school districts). See paragraph 10.34 for a discussion of the situation where the implementation regulations of certain federal agencies define the entity to be audited differently than GAAP.

Determining the Audit Period

Fiscal Year and Program Period May Differ

3.28 An audit performed in accordance with Circular A-133 should cover the auditee's financial transactions (including transactions related to federal awards) for its fiscal year (or a two-year period, if allowed by Circular A-133), which is not necessarily the same as the period of the program being funded (see paragraph 2.5 for further information on biennial audits). Thus, the audit might include only a part of the transactions of a federal award, because some transactions may not occur within the period covered by the audit.

Stub Periods

3.29 Stub periods may occur when an auditee converts from a program-specific audit to a single audit or changes audit periods. One example would be

a community college with a September 30 year end that previously had a program-specific audit and is now converting to a single audit. The prior program-specific audits were performed based on a June 30 award year. The first single audit will be for the year ending September 30. This would leave the community college with an unaudited stub period of June 30 to September 30. Arrangements should be made to meet the audit requirements for federal expenditures during the stub period. This is usually done either as a separate audit of the stub period or by including expenditures of the stub period with the following period's Circular A-133 audit. The cognizant or oversight agency for audit or the pass-through entity should be contacted for advice on how stub periods should be addressed.

Initial-Year Audit Considerations

Preceding Period Audited by Another Auditor

3.30 Whenever an auditor is considering accepting an engagement in which the federal awards of the preceding period were audited by another auditor, he or she should refer to the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). It provides guidance on communications between predecessor and successor auditors when a change in auditors is in process or has taken place, and it includes illustrative letters. SAS No. 84 also provides communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor.

Factors to Consider Under the Risk-Based Approach

3.31 When the engagement includes the selection of major programs using the risk-based approach, an auditor accepting, or contemplating accepting, an engagement should consider gathering information about the following:

- Federal awards expended by federal program
- Prior-period findings and questioned costs (including the corrective action plan and management decision related to the findings and summary schedule of prior audit findings)
- Whether a predecessor auditor used the exception that allows deviation from the risk-based approach during the last three years (see paragraph 7.20)
- Correspondence from program officials indicating potential problems
- New programs
- Changes to programs
- Amount of funding passed through to subrecipients by individual federal program
- Extent to which computer processing is used to administer federal programs
- Federal programs audited as major programs for the last two years

Timing of the Completion of the Audit and Reporting Submission Deadlines

3.32 When planning the timing of the audit, auditors should be aware that Circular A-133 requires that the audit be completed and the data collection form and reporting package (described in paragraphs 2.24, 2.25, 10.6, 10.7,

and 10.71 through 10.73) be submitted to the federal clearinghouse within a certain time period. The timing requirements are discussed in detail in paragraphs 10.74 through 10.79.

Determining the Major Programs to Be Audited

3.33 As discussed in paragraphs 2.16 through 2.19, Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. This determination will affect the scope of the audit and the compliance requirements to be tested. The determination of major programs is discussed further in chapter 7.

Preliminary Assessment of Audit Risk

3.34 As required by SAS No. 54, the auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. While not explicitly stated in SAS No. 54, it has generally been interpreted that the phrase “laws and regulations” implicitly includes provisions of contracts and grant agreements. (Auditors should note that *Government Auditing Standards* explicitly states that the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with the provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statements amounts.) Circular A-133 further requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. In developing an audit plan, the auditor should assess the risk that noncompliance may cause the financial statements to contain a material misstatement or may have a material effect on each major program. Furthermore, the auditor should consider risk factors related to the risk of noncompliance with those laws, regulations, and provisions of contracts and grant agreements and to the related control activities designed to prevent or to detect such noncompliance. As required by SAS No. 82, the auditor should also specifically assess the risk of material misstatement of the financial statements because of error or fraud and should consider that assessment in designing the audit procedures to be performed (see paragraphs 4.32 through 4.37). Audit risk is discussed in greater detail in paragraphs 6.7 through 6.12.

Audit Materiality Considerations

3.35 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor’s consideration of materiality when he or she plans and performs an audit of financial statements in accordance with GAAS. Materiality, as it relates to the financial statement audit, is further discussed in the following related AICPA Audit and Accounting Guides:

- *Not-for-Profit Organizations*
- *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*
- *Health Care Organizations*^[5]

[5] [Deleted.]

Materiality Guidance in Government Auditing Standards

3.36 As noted in paragraph 3.9, *Government Auditing Standards* contains guidance on certain areas, including materiality considerations. Paragraphs 4.6.1 and 4.6.2 of *Government Auditing Standards* state that “auditors’ consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.”

Materiality Differences Between the Financial Statement Audit and the Single Audit

3.37 In auditing compliance with requirements governing major programs in accordance with Circular A-133, the auditor’s consideration of materiality differs from that in an audit of financial statements in accordance with GAAS and *Government Auditing Standards*. In an audit of financial statements, materiality is considered in relation to the financial statements being audited. In designing audit tests and developing an opinion on an auditee’s compliance with requirements having a direct and material effect on each major program, however, the auditor considers materiality in relation to each major program (see paragraphs 6.13 through 6.16 for a further discussion of materiality considerations).

Materiality for Purposes of Reporting Audit Findings

3.38 Circular A-133 requires the auditor to consider a lower level of materiality for purposes of reporting audit findings in the schedule of findings and questioned costs. The auditor should be cautious that this “audit finding” materiality not be confused with (a) the materiality used for planning and performing the single audit, (b) giving an opinion on the financial statements, and (c) giving an opinion on the auditee’s compliance with requirements having a direct and material effect on each major program (see paragraph 3.37 above).

3.39 Among other findings that must be reported, Circular A-133 requires the auditor to report material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program in the schedule of findings and questioned costs (other findings that are required to be reported are described in paragraph 10.63). The auditor’s determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement (for example, activities allowed or unallowed, cash management, eligibility, or reporting) for a major program or an audit objective identified in the *Compliance Supplement*.

3.40 For example, when the auditor discovers one or more instances of noncompliance involving the reporting type of compliance requirement for a particular major program, several materiality determinations must be made using professional judgment. First, the auditor must decide whether the noncompliance is material to the reporting type of compliance requirement for the

particular major program. If the auditor determines the noncompliance is material to the reporting type of compliance requirement, the noncompliance would be reported as a finding in the schedule of findings and questioned costs. Second, the auditor must decide whether the discovered noncompliance is material, either individually or when aggregated with other noncompliance findings, in relation to the particular major program taken as a whole. If the auditor determines the noncompliance is material to the major program taken as a whole, the auditor would express a qualified or adverse opinion on compliance with respect to the particular major program.

Determining Compliance Requirements

3.41 In planning the consideration of the internal control and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements at the start of the audit (see paragraph 4.27 for a listing of possible audit procedures to assess management's identification of compliance requirements). The auditee and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the *Compliance Supplement*. For programs not included in the *Compliance Supplement*, auditors should refer to part 7 of that document, which provides guidance for auditing programs not included in the *Compliance Supplement*. Among other things, part 7 instructs auditors to review the federal award document and referenced laws and regulations applicable to the program, the CFDA, and previously issued compliance supplements (see paragraph 6.30 for further information).

Developing an Efficient Audit Approach

3.42 Auditors should consider planning and performing a single audit to achieve maximum audit efficiency. Examples of ways to achieve audit efficiency follow.

- The financial statement audit and the single audit could be planned at the same time.
- If the auditee's system administers more than one major program using common internal control, the transactions of those programs could be combined into one population for selecting sample sizes. When testing transactions selected from the major programs, the auditor could use the sample to test internal control over financial reporting, internal control over compliance, and compliance requirements.
- Since Circular A-133 requires the planning and performance of internal control work to assess control risk as low (unless weaknesses are found), the auditor could take advantage of the low assessed level of control risk when he or she performs the substantive testing of compliance.
- Helpful quality control materials (such as planning checklists and reporting checklists) could be used.

Joint Audits and Reliance on Others

3.43 Circular A-133 encourages auditees, whenever possible, to make positive efforts to utilize small business, minority-owned firms, and women's business enterprises. In keeping with the spirit of this provision, certain auditees may engage such independent accounting firms on a joint-venture or

subcontract basis. In these instances it may be necessary to refer to the work of other auditors. Prior to entering into an agreement to perform a joint audit or to subcontract with another firm, the auditor should consider SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, and Ethics Interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements*.*

3.44 In some circumstances, each of the auditors participating in the single audit will jointly sign the audit reports. This is appropriate only when each auditor or firm has complied with GAAS and *Government Auditing Standards* and is in a position that would justify being the only signatory of the report.

3.45 If part of the single audit is performed by governmental auditors, the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of *Government Auditing Standards* as well as the CPE and quality control standards. These standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.*

3.46 Another common occurrence, particularly in a governmental environment, is the separation of a single audit between the principal auditor of the reporting entity and a secondary auditor of a component unit included in the financial statements of the reporting entity (see paragraph 3.27). The principal auditor's report on the financial statements of the reporting entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component unit. The principal auditor may also need to refer to the programs audited by other auditors in his or her reports on the schedule of expenditures of federal awards, compliance, and internal control related to federal awards, as they relate to federal awards administered by the component unit. In such cases, the auditor should follow the guidance in SAS No. 1, section 543.

Existence of Internal Audit Function

3.47 Another factor the auditor should consider when planning the single audit is whether the auditee has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with specified requirements. The auditor should consider the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters (for example, in obtaining an understanding of the entity's internal control over financial reporting and compliance, assessing audit risk, and performing substantive procedures).

Communications With the Cognizant Agency for Audit and Others

3.48 When professional judgment indicates it is appropriate, the auditor may communicate with the cognizant agency for audit, the oversight agency for

* See footnote * in paragraph 3.8.

audit, federal awarding agencies, pass-through entities, state auditors, or state awarding agencies, to aid in planning the audit. The auditor might want to consider documenting such communications, as well as any decisions rendered as a result. If a planning meeting is held, matters such as the following may be discussed:

- The audit plan
- The scope of the compliance testing of federal programs
- The intended use of the *Compliance Supplement*
- The identification of federal awards, including those that are considered to be major programs
- The form and content of the supplemental schedule of expenditures of federal awards
- The testing of the monitoring of subrecipients
- The scope of the review and testing of internal control
- The testing of compliance requirements
- The status of prior-year findings and questioned costs
- Federal agency or pass-through entity management decisions on prior-year findings
- Compliance requirements and any changes to those requirements

Understanding the Applicable State and Local Compliance and Reporting Requirements

Impact on Circular A-133 Audit

3.49 Auditors may be engaged to test and report on compliance with state and local laws and regulations in addition to testing and reporting on the compliance requirements imposed by *Government Auditing Standards* and Circular A-133. For example, there may be state-imposed state award requirements that provide state funds to political subdivisions or NPOs (in this example, the state is not a pass-through entity). Even though such nonfederal awards are not considered part of the total federal awards expended by the auditee and are not subject to audit in accordance with Circular A-133, auditors would still need to consider such laws and regulations under GAAS and *Government Auditing Standards*. Therefore, in connection with the financial statement audit, auditors should obtain an understanding of applicable state and local compliance and reporting requirements that have a direct and material effect on the financial statements being audited.

Compliance Audits of State or Local Grants

3.50 When engaged to audit one or more grants subject to state or local compliance requirements, the auditor should consider performing the following procedures:

- Determine whether the state or local government has a compliance supplement or other audit guide for the program.
- Inquire of management about the additional compliance auditing requirements applicable to the entity.
- Inquire of the audit divisions of the sponsoring agencies about the audit requirements applicable to the entity.

- Obtain any applicable audit guidance from the grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- Read the grant agreements and any amendments, including referenced laws and regulations.
- Review information about governmental audit requirements that is available from state societies of CPAs or associations of governments.
- When appropriate, discuss with the grantor agency the scope of the testing that is expected to be performed.

Compliance Audits Not Involving Governmental Assistance

3.51 Guidance for engagements related to management's written assertion about an entity's compliance with (or management's written assertion about) specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, Chapter 6, "Compliance Attestation" (AICPA, *Professional Standards*, vol. 1, AT sec. 601).

Desk Reviews and On-Site Reviews

3.52 In addition to the quality control requirements set forth in *Government Auditing Standards* (see paragraphs 3.12 and 3.13), cognizant agencies for audit have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews (note that the oversight agencies for audit may also perform these reviews).^{*} As a part of the cognizant agencies' evaluation of the completed reports of such engagements, and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the federal agency. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency for audit and the independent auditor. (See the additional discussion in paragraphs 3.21 and 3.22 regarding working paper access issues.)

3.53 Whenever a review of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the cognizant agency for audit determines that the audit report and the working papers are substandard, cognizant agencies may take further steps. In those instances in which the audit was determined to be substandard by the federal agency, the matter may be submitted to state boards of public accountancy.

Restriction on the Auditor's Preparation of Indirect Cost Proposals

3.54 Circular A-133 precludes the auditor who prepares the indirect cost proposal or cost allocation plan from performing the single audit when indirect

^{*} Among the tools that the cognizant and oversight agencies for audit use to perform desk reviews are two checklists from the President's Council on Integrity and Efficiency (PCIE)—the *Uniform Guide for Initial Review of A-133 Audit Reports* and the *Uniform Guide for Initial Review Guide for A-133 Audits*. Copies of these Guides are available on the Internet at www.ignet.gov/pande/audit/psingle.html.

costs recovered during the prior year by the auditee exceed \$1 million.* This restriction applies to the base year used in the preparation of the indirect proposal or cost allocation plan and to any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998. For example, an auditor who prepares an indirect cost proposal or cost allocation plan that is used as the basis for charging indirect costs in the fiscal year ending June 30, 1999, is not permitted to perform the 1999 single audit (assuming that the indirect costs recovered during the prior year exceeded \$1 million).

Exit Conference

3.55 Upon completion of fieldwork, the auditor should consider holding a closing or exit conference with senior officials of the auditee. The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of his or her facts and conclusions, including whether or not management concurs with the audit findings. This conference also serves to provide the auditee with advance information so that it may initiate corrective action without waiting for a final audit report. In the case of decentralized operations, as at a university, auditors should consider having preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and the administration of sponsored projects.

3.56 The auditor should consider documenting the names of the auditors who conducted the exit conference, the names and positions of the representatives with whom exit conferences were held and any comments that they had, and other details of the discussions.

* In January 2002, the U.S. General Accounting Office issued Amendment No. 3 to *Government Auditing Standards* titled *Independence*. It is effective for audits of periods beginning on or after October 1, 2002, with early implementation encouraged. See footnote * to paragraph 3.8 for additional information on Amendment No. 3. Paragraph 3.26(d) of Amendment No. 3 addresses the effect that the preparation of an entity's indirect cost proposal or cost allocation plan has on an auditor's independence. However, even if the auditor's preparation of an indirect cost proposal or cost allocation plan does not impair the auditor's independence, Circular A-133 continues to prohibit an auditor who prepared that proposal or plan from performing the Circular A-133 audit when indirect costs recovered by the entity during the prior year exceeded \$1 million.

Chapter 4

FINANCIAL STATEMENT AUDIT CONSIDERATIONS UNDER CIRCULAR A-133

Introduction

4.1 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, their results of operations or changes in net assets, and, where appropriate, their cash flows for the fiscal year. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits and prepare separate financial statements (see paragraph 4.5 below). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

4.2 Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. However, auditees are required to disclose the basis of accounting and significant accounting policies used in preparing the financial statements. Auditees must be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

4.3 Circular A-133 does, however, require the auditor to report whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP). This results in the expression of an opinion or a disclaimer of opinion. (Guidance on reporting on the financial statements of the auditee appears in chapter 10.) If the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP,¹ the auditor is still required to express or disclaim an opinion and should follow the reporting guidance in SAS No. 62, *Special Reports*.

4.4 The financial statements are also required to be audited in accordance with *Government Auditing Standards* (see paragraphs 3.8 through 3.23, 4.17 through 4.19, and 4.41). Circular A-133 does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*.

4.5 The audit must cover the entire operations of the auditee, or at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards during the fiscal year, provided that each

¹ A comprehensive basis of accounting other than GAAP is defined in paragraph 4 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04).

audit encompasses the financial statements and schedule of expenditures of federal awards for each such department, agency, and other organizational unit (see paragraph 3.27 for a further discussion).

4.6 In performing the financial statement audit, the auditor should refer to the accounting and auditing guidance applicable to specific industries as found in the following AICPA Audit and Accounting Guides: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, *Health Care Organizations*, and *Audits of Colleges and Universities*.²

4.7 In this chapter, the requirements of GAAS related to the auditor's consideration of compliance and internal control over financial reporting in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* in those areas are discussed.

Consideration of Internal Control Over Financial Reporting

4.8 In the following paragraphs the requirements of GAAS and *Government Auditing Standards* applicable to the auditor's consideration of internal control over financial reporting in a financial statement audit are described.

Summary of GAAS Requirements

4.9 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319) provides guidance on the independent auditor's consideration of an auditee's internal control in an audit of financial statements in accordance with GAAS, defines internal control, describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing an audit.

4.10 When obtaining an understanding of internal control over financial reporting and assessing control risk for the assertions embodied in the financial statements, the auditor should refer to SAS No. 55, as amended, and to guidance applicable to specific industries as found in the AICPA Audit and Accounting Guides listed in paragraph 4.6.

Definition of Internal Control

4.11 The definition of internal control in both SAS No. 55, as amended, and Circular A-133 is consistent with the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The definition is as follows:

² Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, its accounting guidance continues to be applicable in a governmental environment (that is, public institutions) for those entities that are not yet required to and have not adopted GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*.

Internal control means a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

Control Objectives

4.12 The three categories of control objectives described previously are what an auditee strives to achieve. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others regarding each separate purpose. In general, controls that are relevant to an audit of financial statements pertain to the auditee's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP (see footnote 1 of this chapter). However, controls pertaining to the operations and compliance objectives may also be relevant to a financial statement audit to the extent that they pertain to data the auditor evaluates or uses in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this SOP as "internal control over financial reporting" and are encompassed in the reporting on internal control required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP as "internal control over compliance" and are encompassed in the report on internal control required by Circular A-133 (see paragraphs 10.46 through 10.49). In a particular single audit engagement, some controls may be relevant to both the audit of the financial statements and the audit of compliance. When this occurs, those controls would be encompassed in both internal control reports. Section 505 of Circular A-133 provides guidance on reporting findings involving reportable conditions in internal control in such a circumstance (see paragraph 10.56).

Components of Internal Control

4.13 The five components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring. SAS No. 55, as amended, requires the auditor to obtain an understanding of each of those components that is sufficient to plan the audit by performing procedures to understand (a) the design of controls relevant to an audit of financial statements, and (b) whether they have been placed in operation. In all audits of financial statements, including those audited as part of a single audit, this understanding incorporates knowledge about the design of controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, as well as knowledge about whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

Relationship Between Objectives and Components

4.14 There is a direct relationship between the three categories of control objectives (what an auditee strives to achieve) and the control components

(what is needed to achieve the objectives). Although an auditee's internal control addresses objectives in each of the categories referred to in the definition of internal control in paragraph 4.11, not all of these objectives and related controls are relevant to an audit of the auditee's financial statements.

Documentation Requirements

4.15 SAS No. 55, as amended, requires the auditor to document the understanding of the auditee's internal control components that was obtained to plan the audit. In addition, the auditor should document the basis for his or her conclusions about the assessed level of control risk. The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as by the nature of the auditee's internal control (see paragraphs 3.18 through 3.22 for a discussion of the additional working paper and documentation requirements of *Government Auditing Standards*). Auditors should refer to SAS No. 55, as amended by SAS No. 78, for more detail on the documentation requirements related to internal control over financial reporting.

Communication Requirements

4.16 The auditor should consult the guidance in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for guidance on identifying and reporting conditions that relate to an entity's internal control over financial reporting observed during an audit of financial statements (see also paragraphs 4.19 and 10.26 through 10.30). The auditor should also consult the guidance in SAS No. 61, *Communication With Audit Committees*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), for required communications to persons who have responsibility for the oversight of the financial reporting process (see also paragraph 10.14).

Responsibilities Under Government Auditing Standards

Fieldwork

4.17 Other than the additional documentation requirement discussed in paragraphs 3.18 and 3.19, *Government Auditing Standards* does not prescribe any additional fieldwork standards with respect to the auditor's consideration of internal control over financial reporting beyond those required in an audit conducted in accordance with GAAS. However, paragraphs 4.21 through 4.30 of *Government Auditing Standards* provide guidance on certain aspects of internal control over financial reporting that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements. These aspects are summarized as follows:

- **Safeguarding of assets.** These are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses that are material to the financial statements. Therefore, the understanding of safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- **Control over compliance with laws and regulations.** These are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help provide reasonable assurance

that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

4.18 The auditor should consider this guidance as it relates to the consideration of the auditee's internal control over financial reporting in the audit of the financial statements.

Reporting

4.19 Reporting on the internal control over financial reporting under *Government Auditing Standards* differs from such reporting under SAS No. 60. *Government Auditing Standards* requires written reporting on internal control over financial reporting in all audits. SAS No. 60 requires communication (either written or oral) only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including the identification of those that are individually or cumulatively material weaknesses. SAS No. 60 permits, but does not require, the auditor to identify and communicate separately, as material weaknesses, those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, which are not addressed by SAS No. 60: (a) a description of the scope of the auditor's testing of internal control and the results of those tests and (b) deficiencies in internal control that are not considered reportable conditions (see the discussion in paragraph 10.29). See paragraphs 3.14 through 3.15 and 10.26 through 10.30 for a more detailed discussion of the reporting and communication requirements related to internal control over financial reporting.

Compliance Considerations

4.20 The auditor should be aware of the unique characteristics of the compliance auditing environment. States, local governments, and not-for-profit organizations differ from commercial enterprises in that they may be subject to diverse compliance requirements. Management is responsible for ensuring compliance with relevant laws and regulations. That responsibility encompasses the identification of applicable laws and regulations and the establishment of internal control designed to provide reasonable assurance that the auditee complies with those laws and regulations.

4.21 In the following paragraphs, the requirements of GAAS that are applicable to the auditor's consideration of compliance in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* are discussed.

Summary of GAAS Requirements

General Guidance

4.22 SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, provides general guidance when the auditor is engaged to audit an entity that receives federal awards, including audits performed under GAAS, *Government Auditing Standards*, and Circular A-133. SAS No. 74 describes the auditor's

responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit and also discusses the auditor's responsibility for compliance auditing related to federal awards in an audit performed under Circular A-133. The auditor's responsibility for compliance auditing related to federal awards is discussed in chapter 6 of this SOP.

4.23 The auditor is required to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations, error, or fraud. SAS No. 54, *Illegal Acts by Clients*, describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors. The requirements of SAS Nos. 54, 82, and 47 are described in paragraphs 4.24 through 4.38.

SAS No. 54 Requirements

4.24 SAS No. 54 requires the auditor to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. This involves identifying laws and regulations that may have a direct and material effect on the determination of financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement. The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

4.25 Although it has not been explicitly stated in SAS No. 54, the phrase "laws and regulations" has generally been interpreted to implicitly include the provisions of contract and grant agreements (see paragraph 3.17). Laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "compliance requirements." Violations of laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "instances of noncompliance."

4.26 In considering whether the financial statements may be materially misstated because of instances of noncompliance, the auditor should—

- Assess whether management has identified compliance requirements that have a direct and material effect on the determination of amounts in the financial statements.
- Obtain an understanding of the possible effects of these compliance requirements on the determination of financial statement amounts.
- Assess the risk that a material misstatement of the financial statements has occurred because of instances of noncompliance.
- Design and conduct the audit to provide reasonable assurance of detecting such material noncompliance.

4.27 The auditor may consider performing the following procedures in assessing management's identification of these compliance requirements and in obtaining an understanding of their possible effects on the determination of financial statement amounts:

- a. Consider knowledge about these compliance requirements that has been obtained from prior years' audits.
- b. Discuss these compliance requirements with the auditee's chief financial officer, legal counsel, or grant administrators.
- c. Obtain written representation from management regarding the completeness of management's identification of compliance requirements (see paragraph 4.40).
- d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- e. Identify sources of revenue, review any related agreements (for example, loan agreements or grant agreements) and inquire about the applicability of any overall governmental regulations to the accounting for the revenue.
- f. Obtain publications pertaining to compliance requirements. These publications often address federal tax and other reporting requirements, such as the Department of the Treasury and the Internal Revenue Service requirements pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- g. Obtain copies of, and review pertinent sections of, the state constitution, laws, and regulations concerning the auditee. The sections of these documents pertaining to financial reporting, debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- h. Review the minutes of meetings of the governing body of the auditee for the enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- i. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about the compliance requirements applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- j. Review information about applicable federal and state program compliance requirements, such as the information included in the *Compliance Supplement*, the CFDA, and state and local policies and procedures.
- k. Review the guidance contained in the applicable AICPA Audit and Accounting Guides referred to in paragraph 4.6 and review the materials available from other professional organizations, such as state societies of CPAs or industry associations.
- l. Inquire of the audit, finance, or program administrators from which grants are received about the restrictions, limitations, terms, and conditions under which such grants were provided. These administrators can usually be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

4.28 In obtaining an understanding of the possible effects on financial statements of compliance requirements that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts, the auditor may consider—

- The materiality of the effect on financial statement amounts.
- The level of management or employee involvement in the compliance-assurance process.
- The opportunity for concealment of instances of noncompliance.

4.29 As part of assessing the risk of material misstatement, the auditor should assess the risk that instances of noncompliance may cause such a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance that are material to the financial statements. Therefore, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from instances of noncompliance that have a direct and material effect on the determination of financial statement amounts (see paragraph 6.53 for a discussion of the impact on the financial statements of actual and projected errors noted in a single audit, and see paragraph 10.42 for a discussion of situations that could occur when the auditor reports on the results of compliance testing).

4.30 Auditees may be affected by many other laws and regulations, including those related to occupational safety and health, environmental protection, equal employment, food and drug, and price fixing. These laws and regulations generally concern an auditee's operations more than financial reporting and accounting. Their effect on an auditee's financial statements is indirect and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. The auditor would not ordinarily have sufficient basis to recognize possible violations of these laws and regulations. Even when violations of such laws and regulations can have consequences that are material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the auditee, or unless there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.³

4.31 If specific information comes to the auditor's attention that provides evidence concerning the existence of possible instances of noncompliance that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an instance of noncompliance occurred. However, because of the characteristics of such noncompliance, an audit made in accordance with GAAS provides no assurance that indirect-effect instances of noncompliance will be detected or that any contingent liabilities that may result will be disclosed.

SAS No. 82 Requirements

4.32 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110), states that the auditor also has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free

³ In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, SAS No. 54 notes that, where applicable, the auditor should also inquire of management concerning (a) the client's policies relative to the prevention of illegal acts and (b) the use of directives issued by the client, as well as periodic representations obtained by the client, from management at appropriate levels of authority, concerning compliance with laws and regulations.

of material misstatement, whether caused by error or fraud. SAS No. 82 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

4.33 Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of financial statements is intentional or unintentional. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets. These two types of misstatements, as well as the characteristics of fraud, are discussed further in paragraphs 3 through 10 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.03 through 316.10).

4.34 The risk of material misstatement of the financial statements due to fraud is part of audit risk. Therefore, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets in each of the following categories:

Misstatements Arising From Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

Misstatements Arising From the Misappropriation of Assets

- Susceptibility of assets to misappropriation
- Controls

The auditor should exercise professional judgment when considering (a) risk factors individually or in combination and (b) whether there are specific controls that mitigate the risk. Risk factors are discussed in greater detail in paragraphs 16 through 25 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU secs. 316.16 through 316.25).

4.35 As noted previously, an auditor's interest specifically relates to fraudulent acts that cause a material misstatement in the financial statements. When the auditor is identifying risk factors and other conditions in an audit of financial statements performed in conjunction with a single audit, the auditor's responsibilities under SAS No. 82 are expanded to include (in addition to the risk factors normally associated with financial statements) the consideration of risk factors associated with the receipt of federal awards that could present a material misstatement of the financial statements. Auditors may wish to refer to the AICPA practice aid titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which includes specific guidance on applying the concepts of SAS No. 82 to several industries, including government, health care, and not-for-profit organizations. Among other things, it identifies example risk factors for those industries, including risk factors that relate to recipients of federal awards.

4.36 In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud. Where risk factors are identified as being present, the documentation should include (a) those risk factors identified and (b) the auditor's response to those risk factors, individually or in combination. In addition, if, during the performance of the audit, fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required, these risk factors or other conditions, as well as any further response that the auditor concluded was appropriate, should also be documented.

4.37 SAS No. 82 also contains requirements on the auditor's response to the results of the assessment of risk, the evaluation of audit test results, and communications about fraud to management, the audit committee, and others. Auditors should refer to SAS No. 82 for a description of the specific requirements in those areas (see also paragraphs 10.18 through 10.20).

SAS No. 47 Requirements

4.38 SAS No. 47, as amended by SAS No. 82, provides guidance to auditors in fulfilling the responsibility described in paragraph 4.32, as it relates to errors, in an audit of financial statements conducted in accordance with GAAS. Errors are described as unintentional misstatements, or as omissions of amounts or disclosures, in financial statements. Errors may involve (a) mistakes in gathering or processing data from which financial statements are prepared, (b) unreasonable accounting estimates arising from oversight or the misinterpretation of facts, and (c) mistakes in the application of accounting principles relating to amounts, classification, the manner of presentation, or disclosure. When the auditor is considering his or her responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, there is no important distinction between error and fraud. There is a distinction, however, in the auditor's response to detected misstatements. An isolated, immaterial error in processing accounting data or in applying accounting principles is generally not significant to the audit. In contrast, when fraud is detected, the auditor should consider its implications for the integrity of management or employees and its possible effect on other aspects of the audit. Auditors should refer to SAS No. 47 for more detailed guidance.

Working Paper Documentation

4.39 The auditor should document the procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 41, *Working Papers*.^{*} (See paragraphs 3.20 through 3.22 of this SOP for a discussion of the *Government Auditing Standards* requirements related to working papers.) The fraud risk factors identified and the auditor's response to those risk factors should be documented in accordance with SAS No. 82 (see paragraph 4.36). The auditor's understanding of internal control over financial reporting as it pertains to compliance with such laws and regulations, as well as the related assessment of control risk, should be documented in accordance with SAS No. 55, as amended (see paragraph 4.15).

Written Representations From Management

4.40 SAS No. 85, *Management Representations*, as amended by SAS No. 89, *Audit Adjustments*, requires the auditor to obtain written representations

^{*} See footnote * to paragraph 3.20.

from management as part of an audit conducted in accordance with GAAS. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. With respect to compliance requirements affecting the financial statement audit, auditors should consider obtaining additional representations from management acknowledging that management (see paragraphs 6.68 and 6.69 for a discussion of additional management representations in a single audit)—

- a. Is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.
- b. Is responsible for establishing and maintaining effective internal control over financial reporting.
- c. Has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- d. Has identified and disclosed to the auditor violations (and possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

Additional Responsibilities Under Government Auditing Standards

4.41 *Government Auditing Standards* prescribes as part of the financial statement audit additional fieldwork and reporting requirements beyond those in GAAS that are related to compliance. The additional fieldwork responsibilities are related to auditor communication, audit follow-up on known material findings and recommendations from previous audits, as well as to working paper access and documentation. (See paragraphs 3.14 through 3.22 of this SOP for a further discussion of the additional fieldwork requirements of *Government Auditing Standards*.) With regard to reporting, *Government Auditing Standards* requires, among other things, that the auditor report on the scope of his or her testing of compliance and present the results of those tests. See paragraphs 10.15 and 10.16 for a more detailed discussion of the *Government Auditing Standards* reporting requirements related to compliance.

Reasonable Assurance

4.42 SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), states that since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with GAAS.

Chapter 5

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Overview of Schedule Requirements

5.1 Circular A-133 requires the auditor to determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. This schedule, prepared by the auditee, reports the total expenditures for each federal program (see paragraph 1.18 for the Circular A-133 definition of federal programs). In this chapter the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, non-cash awards, and endowment funds are described. The auditor's reporting on the schedule is discussed in paragraphs 10.36 and 10.37.

Identification of Federal Awards

Federal Agency and Pass-Through Entity Requirements

5.2 Circular A-133 requires federal agencies and pass-through entities to identify the federal awards made by informing each recipient or subrecipient of the CFDA title and number, the award's name and number, the award year, and whether the award is for R&D. When some of this information is not available, the federal agency or pass-through entity is required to provide the information necessary to describe the federal award clearly.

Auditee Requirements

5.3 Circular A-133 also requires the auditee to identify in its accounts all federal awards received and expended, as well as the federal programs under which they were received. Federal program and award identification includes, as applicable, the CFDA title and number, the award number and year, the name of the federal granting agency, and the name of the pass-through entity.

Auditor Assessment of Auditee Identification of Federal Programs

5.4 In assessing the appropriateness and completeness of the auditee's identification of federal programs in the schedule, the auditor should consider, among other matters, evidence obtained from audit procedures performed to evaluate the completeness and classification of recorded revenues and expenditures. This may include sending confirmations to granting federal agencies or pass-through entities in an audit of a subrecipient. When the auditee is unable to identify federally funded expenditures separately, the auditor should consider whether a reportable condition exists. If it does, a finding should be reported in the schedule of findings and questioned costs (see chapter 10 for a further discussion of reporting findings and the schedule of findings and questioned costs).

General Presentation Requirements

Basis of Accounting

5.5 Circular A-133 does not prescribe the basis of accounting that must be used by the auditee to prepare the schedule of expenditures of federal awards. Some auditees may choose to prepare the schedule on a basis of accounting that is different from that in the financial statements. In any case, the auditee is required to disclose the basis of accounting and the significant accounting policies used in preparing the schedule. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

Required Schedule Contents

5.6 Circular A-133 requires the auditee to prepare a schedule of expenditures of federal awards for the period covered by the auditee's financial statements. At a minimum, the schedule should—

- List individual federal programs by federal agency. For federal programs included in a cluster of programs (see paragraphs 1.18, 1.19, and 2.18), list individual federal programs within a cluster of programs. For R&D, the total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services (the federal agency).
- Include, for federal awards received as a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity.
- Provide the total federal awards expended for each individual federal program and the CFDA number or other identifying number when the CFDA information is not available.
- Include notes that describe the significant accounting policies used in preparing the schedule.
- Identify, to the extent practical, the total amount provided to subrecipients by pass-through entities from each federal program (see chapter 9 for a further discussion of the audit considerations of federal pass-through awards).
- Include, in either the schedule or a note to the schedule, the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end (see paragraph 5.13).

Example schedules of expenditures of federal awards appear in appendix C.

Providing Additional Information

5.7 Although not required, the auditee may choose to provide other information (in addition to the foregoing requirements) that is requested by federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a federal program has multiple award years, the auditee may choose to list the amount of federal awards expended for each award year separately, if so requested by a federal agency.

Schedule Not in Agreement With Other Federal Award Reporting

5.8 Auditors should note that the information included in the schedule may not fully agree with other federal award reports that the auditee submits directly to federal granting agencies because, among other reasons, the award reports (a) may be prepared for a different fiscal period and (b) may include cumulative (from prior years) data rather than data for the current year only.

Inclusion of Nonfederal Awards

5.9 Circular A-133 does not require nonfederal awards (for example, state awards) to be presented in the schedule. However, to meet state or other requirements, auditees may decide to include such awards in the schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

CFDA Number Not Available

5.10 The auditee may be unable to obtain the CFDA number, which is sometimes the case for new federal programs and R&D programs. In addition, cost-type contracts will normally not have a CFDA number. When the CFDA number is not available, the auditee should indicate that fact and should include in the schedule the program's name and, if available, other identifying number.

Pass-Through Awards

Treatment of Pass-Through Awards

5.11 Circular A-133 defines a subrecipient as an entity that expends federal awards that are received from a pass-through entity to carry out a federal program. State or local government redistributions of federal awards to subrecipients, known as "pass-through awards," should be treated by the subrecipient as though they were received directly from the federal government. Accordingly, pass-through awards should be included in the scope of the single audit on the same basis as that of federal awards that are received directly. The audit considerations of federal pass-through awards are discussed further in chapter 9. As noted in paragraph 5.6, in addition to the other general presentation requirements, Circular A-133 requires the schedule to include the name of the pass-through entity and the identifying number assigned by the pass-through entity for federal awards received as a subrecipient.

Commingled Assistance

5.12 The individual sources (that is, federal, state, and local) of federal awards may not be separately identifiable because of commingled assistance from different levels of government. If the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule, with a footnote describing the commingled nature of the funds.

Noncash Awards

Treatment of Noncash Awards

5.13 Most federal awards are in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions. These programs may include food stamps, commodities, loan guarantees, loans, surplus property, interest rate subsidies, or insurance. Circular A-133 requires the value of federal awards expended in the form of noncash assistance (such as loan guarantees, loans, insurance programs, surplus property, food stamps issued, or commodities distributed) to be reported either on the face of the schedule or disclosed in the notes to the schedule. The OMB states in Circular A-133 that although it is not required, it is preferable to present this information in the schedule rather than in the notes to the schedule. See paragraphs 2.13 and 2.14 for a discussion on determining when awards, including noncash awards, are considered to be expended.

Determining the Value of the Noncash Awards Expended

5.14 Table 5.1 shows the bases generally used to determine the value of noncash awards expended (see section 205 of Circular A-133 for additional details).

Loan and Loan Guarantee Continuing Compliance Requirements

5.15 As noted previously, in determining the value of total noncash awards expended for loans and loan guarantees, the balances of loans from previous years must be included if the federal government imposes continuing compliance requirements. Circular A-133 does not specifically define the term *continuing compliance requirements*. Therefore, it is a matter of judgment as to whether continuing compliance requirements are significant enough to require inclusion of prior-year loan or loan guarantee balances. For example, if in a prior year an auditee expended the proceeds of a federal loan to construct a building, and the current-year activity consists only of loan repayments and a requirement by the federal lender for the auditee to submit a report that only details loan payment information, it may not be necessary to include the prior year's loan balance in determining the total amount of loans expended. However, if the federal lender requires the auditee to ensure on an ongoing basis that a certain percentage of the building is rented to low-income residents, it would likely be necessary to include the prior year's loan balance in determining the total amount of loans expended. The auditor should consider contacting the federal agency Office of Inspector General for assistance in determining whether continuing compliance requirements are significant enough to require inclusion of the balances of prior loans or loan guarantees.

Table 5.1**Determining the Value of Noncash Awards Expended**

<i>Types of Noncash Awards</i>	<i>Basis Used to Determine the Value of Noncash Awards Expended</i>
Loans and loan guarantees	Value of new loans made or received during the fiscal year plus the balance of loans from previous years for which the federal government imposes continuing compliance requirements (see paragraph 5.15), plus any interest subsidy, cash, or administrative cost allowance received.
Loans and loan guarantees (loans) at institutions of higher education	When loans are made to students but the institution of higher education does not make the loans, only the value of loans made during the year are considered federal awards expended. The balance of loans for previous years is not included because the lender accounts for the prior balances.
Insurance	Fair market value of insurance contract at the time of receipt, or the assessed value provided by the federal agency.
Food stamps	Fair market value of food stamps at the time of receipt, or the assessed value provided by the federal agency.
Commodities	Fair market value of commodities at the time of receipt, or the assessed value provided by the federal agency.
Donated property or donated surplus property	Fair market value of donated property or donated surplus property at the time of receipt, or the assessed value provided by the federal agency.
Free rent	Fair market value of free rent at the time of receipt, or the assessed value provided by the federal agency. Free rent is not considered an award expended unless it is received as part of an award to carry out a federal program.

* The proceeds of loans that were received and expended in prior years are not considered federal awards expended when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

Endowment Funds

5.16 Circular A-133 states that the cumulative balance of federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

Chapter 6

COMPLIANCE AUDITING APPLICABLE TO MAJOR PROGRAMS

6.1 In this chapter the auditor's consideration of compliance requirements applicable to major programs in a single audit under Circular A-133 is discussed (as noted in paragraph 11.5, much of the guidance in this chapter would also be applicable to a program-specific audit when a program-specific audit guide is not available). The consideration of internal control over compliance for major programs is discussed in chapter 8. The related reporting requirements are discussed in chapter 10. The auditor's consideration of the auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements in a financial statement audit is discussed in chapter 4.

Single Audit Compliance Objectives

6.2 In addition to a financial statement audit in accordance with GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs (these are hereinafter referred to as "compliance requirements"). A single audit results in the auditor expressing an opinion on the auditee's compliance with these compliance requirements for each of its major programs. To express such an opinion, the auditor accumulates sufficient evidence by planning and performing tests of transactions and such other auditing procedures as are necessary in support of the entity's compliance with applicable compliance requirements, thereby limiting audit risk to an appropriately low level.

Responsibilities of Auditee

6.3 The auditee is responsible (a) for complying with the compliance requirements related to each of its federal programs and (b) for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. The auditor should obtain management's written representations regarding its compliance and internal control responsibilities as discussed in paragraphs 6.68 and 6.69.

6.4 The form and extent of the documentation of management's compliance will vary depending on the nature of the compliance requirements and the size and complexity of the entity. The auditee may have documentation in the form of accounting or statistical data, case files, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports.

Use of Professional Judgment

6.5 The planning, conduct, and evaluation of the results of compliance testing in a single audit require the auditor to exercise professional judgment. The following factors may be considered by the auditor in applying his or her professional judgment:

- The assessment of inherent risk, control risk, and fraud risk
- The assessment of materiality
- The evidence obtained from other auditing procedures
- The amount of expenditures for the program
- The diversity or homogeneity of expenditures for the program
- The length of time that the program has operated, or changes in its conditions
- The current and prior auditing experience with the program, particularly findings in previous audits and other evaluations (that is, inspections, program reviews, or system reviews required by the federal acquisition regulations)
- The extent to which the program is carried out through subrecipients, as well as the related monitoring activities
- The extent to which the program contracts for goods or services
- The level to which the program is already subject to program reviews or other forms of independent oversight
- The expectation of noncompliance or compliance with the applicable compliance requirements
- The extent to which computer processing is used to administer the program, as well as the complexity of the processing
- Whether the program has been identified as being high-risk by the OMB in the *Compliance Supplement*

Audit Risk Considerations

6.6 To express an opinion on compliance, the auditor accumulates sufficient evidence in support of compliance, thereby limiting audit risk to an appropriately low level. The auditor's consideration of audit risk and materiality when he or she plans and performs a single audit is similar to the consideration in a financial statement audit in accordance with SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

Components of Audit Risk

6.7 Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance. It is composed of inherent risk, control risk, fraud risk, and detection risk. For the purposes of a single audit, these components are defined as follows:

- *Inherent risk*—the risk that material noncompliance with a major program's compliance requirements could occur, assuming there is no related internal control

- *Control risk*—the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the entity's internal control
- *Fraud risk*—the risk that intentional material noncompliance with a major program's compliance requirements could occur
- *Detection risk*—the risk that the auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major program does not exist when, in fact, such noncompliance does exist

In paragraphs 6.8 through 6.12, each of these components of audit risk is discussed and an explanation of how the components of audit risk interrelate in providing a basis for the auditor's opinion on compliance is given.

Inherent Risk

6.8 In assessing inherent risk, the auditor should consider factors that are relevant to compliance engagements. Such factors include the following (the factors listed in paragraph 6.5 should also be considered):

- The complexity of the compliance requirements
- The length of time the entity has been subject to the compliance requirements
- Prior experience with the entity's compliance
- The potential impact of noncompliance, both qualitatively and quantitatively

6.9 The auditor's assessment of inherent risk over major programs may be performed in part when the auditor is determining major programs using the risk-based approach (see paragraph 7.36). The nature of some programs may indicate higher inherent risk. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides the following examples for program characteristics with potentially higher inherent risks:

- Complex programs and the extent to which a program contracts for goods and services have the potential for higher risk. For example, federal programs that disburse funds through third-party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high risk for time-and-effort reporting but may otherwise be at low risk.
- The phase of a federal program's life cycle at the federal agency may indicate risk. For example, a new program with new or interim regulations may have a higher risk than an established program with time-tested regulations. In addition, significant changes in federal programs, laws, or regulations or in the provisions of contracts or grant agreements may increase risk.
- The phase of a program's life cycle at the auditee may indicate risk. For example, during the first and last years in which an auditee participates in a program, the risk may be higher because of the start-up or closeout of the program's activities and staff.
- Type B programs with larger federal awards expended would be of higher risk than would programs with substantially smaller federal awards expended.

Control Risk

6.10 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs, to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The circular does not, however, actually require the achievement of a low assessed level of control risk. The assessment of control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major program. The process of assessing control risk (together with assessing inherent risk and fraud risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for his or her opinion on compliance. The auditor's consideration of internal control over compliance for major programs, including the assessment of control risk, is discussed in chapter 8.

Fraud Risk

6.11 SAS No. 82 provides guidance to the auditor on his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud (see paragraphs 4.32 through 4.37). Because SAS No. 82 only applies to an audit of financial statements, its requirements do not apply to an audit of an auditee's compliance with specified requirements applicable to its major programs. However, as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. Auditors may wish to refer to the AICPA practice aid titled, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which identifies example risk factors that relate to recipients of federal awards. When the auditor has assessed fraud risk and has deemed that a further response is necessary, the guidance in paragraphs 26 through 32 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.26–.32) may be helpful.

Detection Risk

6.12 In determining an acceptable level of detection risk, the auditor considers his or her assessments of inherent risk, control risk, and fraud risk, and the extent to which he or she seeks to restrict the audit risk related to the major program. As assessed inherent risk, control risk, or fraud risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the compliance tests performed based on the assessments of inherent risk, control risk, and fraud risk. Circular A-133 states that compliance testing must include tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance. Such compliance testing serves to limit detection risk.

Materiality Considerations

6.13 In a compliance audit, the auditor's consideration of materiality differs from that in an audit of financial statements (see paragraphs 3.35 through 3.40). Materiality is affected by (a) the nature of the compliance requirements,

which may or may not be quantifiable in monetary terms, (b) the nature and frequency of noncompliance identified with an appropriate consideration of sampling risk, and (c) qualitative considerations, such as the needs and expectations of federal agencies and pass-through entities. Qualitative factors that indicate that an identified instance of noncompliance may be immaterial include (a) a low risk of public or political sensitivity, (b) a single exception that has a low risk of being pervasive, or (c) an indication, based on the auditor's judgment and experience, that the affected federal agency or pass-through entity would normally not need to resolve the finding or take follow-up action.

Materiality Judgments About Compliance Applied to Each Major Program Taken as a Whole

6.14 In designing audit tests and developing an opinion on the auditee's compliance with compliance requirements, the auditor should apply the concept of materiality to each major program taken as a whole, rather than to all major programs combined.

6.15 For purposes of evaluating the results of compliance testing, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by law, regulation, contract, or grant that results in an aggregation of noncompliance (that is, the auditor's best estimate of the overall noncompliance) that is material to the affected federal program. It should be noted that several instances of noncompliance that may not be individually material should be assessed to determine if, in the aggregate, they could have a material effect. Because the auditor expresses an opinion on each major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance, as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one audit to the next.

Effect of Material Noncompliance on the Financial Statements

6.16 If the tests of compliance reveal material noncompliance at the major program level, the auditor should consider its effect on the financial statements. The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. (See also paragraphs 6.53 and 10.42.)

Performing a Compliance Audit

6.17 The auditor should exercise (a) due care in planning and performing the audit and in evaluating the results of his or her audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

6.18 In performing compliance tests, the auditor should—

- a. Identify the auditee's major programs to be tested and reported on for compliance (paragraph 6.19 and chapter 7).
- b. Identify the applicable compliance requirements (paragraphs 6.20 through 6.30).
- c. Plan the engagement (paragraphs 6.31 through 6.34 and chapter 3).
- d. Consider relevant portions of the entity's internal control over compliance for major programs (paragraph 6.35 and chapter 8).
- e. Obtain sufficient evidence, which involves testing compliance with applicable compliance requirements (paragraphs 6.36 through 6.47).
- f. Consider subsequent events (paragraphs 6.48 through 6.50).
- g. Form an opinion about whether the auditee complied with the applicable compliance requirements (paragraphs 6.51 through 6.60).
- h. Perform follow-up procedures on previously identified findings (paragraph 6.61 through 6.67).

Identifying Major Programs to Be Tested

6.19 Circular A-133 requires the auditor to determine the major programs to be tested in a single audit using a risk-based approach. The application of the risk-based approach to determine major programs is discussed in chapter 7.

Identifying Applicable Compliance Requirements

6.20 The auditor must determine the applicable compliance requirements to be tested and reported on in a single audit (that is, those laws, regulations, and provisions of contracts or grant agreements that may have a direct and material effect on each major federal program). The auditor should use professional judgment in making this determination.

Compliance Supplement

6.21 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits (see paragraphs 1.27 through 1.29, 2.34, and 2.35 for additional discussion of the *Compliance Supplement* and for instructions on how to obtain a copy). The *Compliance Supplement* identifies the fourteen types of compliance requirements applicable to most federal programs. It also includes the compliance requirements specific to certain of the largest federal programs. Part 7 of the *Compliance Supplement* provides guidance to assist the auditor in identifying the compliance requirements for federal programs not included in the *Compliance Supplement* (see also paragraph 6.30).

Fourteen Types of Compliance Requirements

6.22 Part 3 of the *Compliance Supplement* lists and describes the fourteen types of compliance requirements and the related audit objectives that the auditor should consider in every audit conducted under Circular A-133, with the exception of program-specific audits performed in accordance with a federal agency's program specific audit guide (see paragraph 11.4). Suggested audit procedures are also provided to assist the auditor in planning and performing tests of the auditee's compliance with the requirements of federal programs. The auditor's judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives

and whether additional or alternative audit procedures are needed (see paragraph 6.44). The fourteen types of compliance requirements are as follows:

- A—activities allowed or unallowed
- B—allowable costs/cost principles
- C—cash management
- D—Davis-Bacon Act
- E—eligibility
- F—equipment and real property management
- G—matching, level of effort, earmarking
- H—period of availability of federal funds
- I—procurement and suspension and debarment
- J—program income
- K—real property acquisition and relocation assistance
- L—reporting
- M—subrecipient monitoring
- N—special tests and provisions

The auditor should consider the applicability of these compliance requirements to the auditee's major programs. Part 2 of the *Compliance Supplement* provides a matrix that is useful to the auditor for this purpose by identifying whether particular compliance requirements apply to the federal programs included in the *Compliance Supplement*. In making a determination not to test a compliance requirement identified as applicable to a particular program, the auditor must conclude either that the requirement does not apply to the particular auditee or that noncompliance with the requirements could not have a material effect on a major program.

Keeping Abreast of Changes in Compliance Requirements

6.23 Circular A-133 states that an audit of the compliance requirements related to federal programs contained in the *Compliance Supplement* will meet the requirements of the circular. However, it also states that when there have been changes to the compliance requirements and the changes are not reflected in the *Compliance Supplement*, the auditor must determine the current compliance requirements and modify the audit procedures accordingly.

6.24 Although Circular A-133 provides that federal agencies are responsible to inform the OMB annually of any updates needed to the *Compliance Supplement*, the auditor should recognize that laws and regulations change periodically and that delays will occur between such changes and revisions to the *Compliance Supplement*. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current. Besides describing the compliance requirements, the *Compliance Supplement* includes references to the Code of Federal Regulations and other sources of information about the requirements. The auditor may refer to those other sources of information to identify significant changes to the requirements or perform other procedures, including the following:

- Discussions with appropriate individuals within the auditee organization (that is, the chief financial officer, internal auditors, legal counsel, the compliance officer, or grant or contract administrators)
- A review of contracts or grant agreements, new guidance material issued by the granting agency or pass-through entity (for example, handbooks and operating procedures), and correspondence from the granting agency or pass-through entity

- An inquiry of granting agency personnel (appendix III of the *Compliance Supplement* includes a listing of federal agency contacts, including addresses, phone numbers, and E-mail or Web page addresses that could be useful if the auditor decides to make such an inquiry)

Considering Additional Provisions of Contracts or Grant Agreements

6.25 The *Compliance Supplement* states that in addition to the compliance requirements identified in the supplement, auditors need to consider whether there are any provisions of contracts or grant agreements that are unique to a particular entity (for example, the grant agreement may specify the matching percentage, or an entity may have agreed to additional requirements that are not required by law or regulation, perhaps as part of a resolution of prior audit findings).

6.26 Therefore, in using the *Compliance Supplement* to identify applicable compliance requirements, the auditor needs to consider—

- a. The applicability to the federal program of the fourteen types of compliance requirements identified in part 3 of the *Compliance Supplement*.
- b. Additional compliance requirements specific to the federal program as identified in part 4 of the *Compliance Supplement*.
- c. Any provisions of contracts or grants that are unique to the particular entity.

Compliance Requirements Specific to Certain Federal Programs

6.27 Part 4 of the *Compliance Supplement* discusses program objectives, program procedures, and compliance requirements that are specific to each federal program included. With the exception of special tests and provisions, the auditor should refer to part 3 of the *Compliance Supplement* for the audit objectives and suggested audit procedures that pertain to the compliance requirements associated with each program. Since special tests and provisions are unique to each program, the audit objectives and suggested audit procedures for each program are included in part 4.

Compliance Requirements Specific to a Cluster of Programs

6.28 As noted in paragraph 2.18, a cluster of programs is a grouping of closely related programs that have similar compliance requirements (for example, SFA, R&D, and other clusters). Part 5 of the *Compliance Supplement* identifies those programs that are considered to be clusters of programs. It also provides compliance requirements, audit objectives, and suggested audit procedures for the clusters.

Relationship of the Compliance Supplement to Federal Program Audit Guides

6.29 The *Compliance Supplement* states that for single audits, the supplement replaces federal agency audit guides and other audit requirement documents for individual federal programs.^[1] Accordingly, for a federal program included in the *Compliance Supplement* and having a separate federal

^[1] [Deleted.]

program audit guide or other federal program audit requirement documents, the auditor needs to consider only those compliance requirements in the *Compliance Supplement* when performing a single audit (versus a program-specific audit).

Federal Programs Not Included in the Compliance Supplement

6.30 The *Compliance Supplement* does not include all federal programs from which an auditee may receive federal awards. Circular A-133 states that for those federal programs not covered in the *Compliance Supplement*, the auditor should use the fourteen types of compliance requirements (see paragraph 6.22) contained in the supplement as guidance for identifying the types of compliance requirements to test, and should determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements. The auditor should follow the guidance in part 7 of the *Compliance Supplement* for identifying the applicable compliance requirements to test and report on in a single audit. That guidance outlines the following steps to determine which compliance requirements to test:

- a. Identify the applicable compliance requirements for the federal program.
- b. Determine which of the compliance requirements identified in step a could have a direct and material effect on the major program.
- c. Determine which of the compliance requirements identified in step b are susceptible to testing by the auditor.
- d. Determine which of the fourteen types of compliance requirements would the compliance requirements identified in step c fall into.
- e. For special tests and provisions, determine the applicable audit objectives and audit procedures.

Part 7 of the *Compliance Supplement* provides more detailed guidance on the steps to perform to identify applicable compliance requirements.

Planning the Engagement

General Considerations

6.31 Planning a compliance audit involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, auditors need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on compliance. Proper planning and supervision contribute to the effectiveness of audit procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

6.32 Factors to be considered by the auditor in planning a compliance audit include (a) the anticipated level of audit risk related to the compliance requirements on which the auditor will report (see paragraphs 6.6 through 6.12), (b) preliminary judgments about materiality levels for audit purposes (see paragraphs 6.13 through 6.16), and (c) conditions that may require extension or modification of audit procedures.

6.33 The nature, timing, and extent of planning will vary with the nature and complexity of the compliance requirements and the auditor's prior experience with the auditee. As part of the planning process, the auditor should consider the nature, timing, and extent of the work to be performed to accomplish the objectives of the compliance audit. Nevertheless, as the compliance audit progresses, changed conditions may make it necessary to modify planned procedures. For discussion of additional planning considerations, see chapter 3.

Multiple Components

6.34 In a compliance audit in which the auditee has operations in several components (for example, locations or branches), the auditor may determine that it is not necessary to test compliance with requirements at every component. In making such a determination and in selecting the components to be tested, the auditor should consider such factors as the following: (a) the degree to which the specified compliance requirements apply at the component level, (b) judgments about materiality, (c) the degree of centralization of the records, (d) the effectiveness of controls, particularly those that affect management's direct control over the exercise of authority delegated to others, as well as its ability to supervise activities at various locations effectively, (e) the nature and extent of operations conducted at the various components, and (f) the similarity of operations and controls over compliance for different components. See paragraph 8.13 for a discussion of internal control considerations for multiple components.

Consideration of Internal Control Over Compliance for Major Programs

6.35 The auditor should obtain an understanding of relevant portions of internal control over compliance sufficient to plan the audit and to assess control risk for compliance with specified requirements. In planning the audit, the auditor should use this knowledge to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance. Circular A-133 specifically requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. Circular A-133 also requires the auditor to perform testing of controls as planned. In some instances, the auditor may be able to perform compliance testing for major programs concurrently with tests of controls (see paragraph 3.42). Any reportable conditions in internal control over compliance for major programs that are noted are required to be reported as an audit finding (see paragraph 10.63). Control risk is discussed further in paragraph 6.10, and the auditor's consideration of internal control over compliance for major programs (including the final control risk assessment and the performance of tests of controls) is discussed in more detail in chapter 8.

Performing Compliance Testing

6.36 Circular A-133 requires that compliance testing include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Such compliance testing may be performed (a) concurrently with tests of controls, (b) as substantive testing, or (c) as a combination

of the two. In performing compliance testing, the auditor attempts to obtain reasonable assurance that the auditee complied, in all material respects, with the compliance requirements. This includes designing the compliance audit to detect both intentional and unintentional noncompliance. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of internal control over compliance and because much of the evidence available to the auditor is persuasive rather than conclusive in nature. Furthermore, procedures that are effective for detecting unintentional noncompliance may be ineffective for detecting noncompliance that is intentional and is concealed through a collusion between the client's personnel and third parties or among the management or employees of the client. Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

6.37 In determining the nature, timing, and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying his or her judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence. In determining the nature, timing, and extent of the testing of an auditee's compliance with compliance requirements, the auditor should consider audit risk and materiality related to each major program. The auditor plans compliance tests to reduce detection risk to an acceptable level. The evidence provided by these tests, along with evidence regarding inherent risk and control risk, provides the basis for expressing an opinion on whether the auditee complied, in all material respects, with the compliance requirements for each major program.

6.38 In determining the nature of his or her tests of compliance with requirements governing major programs, the auditor should consider the nature of those requirements. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, audit procedures should be designed to provide the auditor with sufficient evidential matter to evaluate how management expended the funds.

Sufficient Evidence

6.39 The auditor should apply procedures to provide reasonable assurance of detecting material noncompliance. The selection and application of procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for expressing an opinion on compliance require the careful exercise of professional judgment. A broad array of available procedures may be applied in a compliance audit. In establishing a proper combination of procedures to restrict audit risk appropriately, the auditor should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- a.* Evidence obtained from independent sources outside an entity provides greater assurance of an entity's compliance than evidence secured solely from within the entity.
- b.* Information obtained from the auditor's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.

- c. The more effective the internal control, the greater the assurance it provides about the entity's compliance.

6.40 Thus, in the hierarchy of available audit procedures, those that involve search and verification (for example, inspection, confirmation, or observation)—particularly when independent sources outside the entity are used—are generally more effective in reducing audit risk than are those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with the individuals responsible for compliance).

6.41 In a compliance audit, the auditor's objective is to accumulate sufficient evidence to limit audit risk to a level that is, in the auditor's professional judgment, appropriately low for the high level of assurance being provided. An auditor should select from all available procedures (that is, procedures that assess inherent, control, and fraud risk and restrict detection risk)—any combination that can limit audit risk to such an appropriately low level.

6.42 For regulatory requirements, the auditor's procedures may include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

Audit Objectives

6.43 As noted in paragraph 6.22, the *Compliance Supplement* contains the audit objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements. The audit objectives are useful in understanding the specific objectives to be satisfied when the auditor performs audit tests and determines whether the noncompliance that is identified is material.

Suggested Audit Procedures

6.44 The *Compliance Supplement* contains suggested audit procedures for testing federal programs for compliance. These suggested audit procedures represent procedures that may be used by the auditor in developing an audit program. The suggested audit procedures may also be useful in testing the same types of compliance requirements for programs that are not included in the *Compliance Supplement*. These suggested audit procedures represent a tool available to the auditor; however, the auditor is neither required to follow these audit procedures nor restricted to using only these procedures. The auditor should use professional judgment in determining the appropriate audit procedures to be performed to allow him or her to obtain sufficient evidence to form an opinion on the auditee's compliance with the compliance requirements that could have a direct and material effect on each major program.

Audit Sampling

6.45 The auditor generally uses audit sampling to obtain evidential matter. There are two approaches to audit sampling: nonstatistical and statistical. Circular A-133 does not require any particular sampling approach in a single audit. The factors to be considered in planning, designing, and evaluating audit samples (including planning a particular sample for a test of controls) are discussed in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350). When planning to test a particular sample of transactions,

the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. Auditors should note that SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, and Circular A-133 require the auditor to determine both the known questioned costs and likely questioned costs associated with audit findings. The determination of likely questioned costs may require the projection of sample results to determine whether a finding is required to be reported in the schedule of findings and questioned costs. Circular A-133 does not require the auditor to report an exact amount or a statistical projection of likely questioned costs, but rather to include an audit finding when the auditor's estimate of likely questioned costs is greater than \$10,000. See paragraph 6.59 for a further discussion of likely questioned costs.

6.46 The AICPA Auditing Practice Release *Audit Sampling* provides guidance to help auditors apply audit sampling in accordance with SAS No. 39. In the Auditing Practice Release, sampling in compliance tests of internal controls and in substantive tests of details, as well as dual-purpose testing is discussed.

Using Separate Samples for Each Major Program

6.47 Although the auditor must obtain sufficient evidence to support an opinion on compliance for each major federal program, separate samples for each major program are not required. Experience has shown, however, that it is preferable to select separate samples from each major program because the separate sample provides clear evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate that the results of such samples, together with other audit evidence, are sufficient to support the opinion on each major program's compliance. As noted in paragraph 6.37, the auditor should be aware that a sample of a few items with a low dollar value and from a large population, generally does not, by itself, provide sufficient evidence.

Consideration of Subsequent Events

6.48 The auditor's consideration of subsequent events in a compliance audit is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). The auditor should consider information about events relating to the applicable compliance requirements that comes to his or her attention after the end of the audit period and prior to the issuance of his or her report.

6.49 Two types of subsequent events require consideration by management and evaluation by the auditor. The first type consists of events that provide additional information about the entity's compliance during the audit period. For the period from the end of the audit period to the date of the auditor's report, the auditor should perform procedures to identify such events. These procedures should include, but may not be limited to, inquiries about and consideration of the following information:

- Relevant internal auditors' reports issued during the subsequent period

- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance that were issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

6.50 The second type of subsequent events consists of noncompliance that occurs subsequent to the audit period but before the date of the auditor's report. The auditor has no responsibility to detect such noncompliance. However, should such noncompliance come to the auditor's attention, it may be of such a nature and significance that the auditor should consider whether the matter is adequately disclosed in the notes to the schedule of expenditures of federal awards.

Evaluation and Reporting of Noncompliance

Instances of Noncompliance (Findings)

6.51 The auditor's tests of compliance with compliance requirements may disclose instances of noncompliance. Circular A-133 refers to these instances of noncompliance as "findings." Such findings may be of a monetary nature and involve questioned costs or may be nonmonetary and not result in questioned costs. Both *Government Auditing Standards* and Circular A-133 specify how certain findings should be reported. The auditor's opinion on compliance and his or her responsibilities for reporting findings are discussed in greater detail in chapter 10.

Compliance Opinion

6.52 Circular A-133 requires the auditor to report on compliance, which includes an opinion or disclaimer of opinion (on each major program) on whether the auditee complied with the applicable compliance requirements, and to prepare a schedule of findings and questioned costs (see paragraphs 10.41 through 10.46 and 10.55 through 10.67 for a further discussion). In evaluating whether the auditee complied with the compliance requirements in all material respects, the auditor should consider (a) the nature and frequency of the noncompliance identified, and (b) whether such noncompliance is material relative to the nature of the compliance requirements. Assessing materiality at the appropriate level is critical to the proper evaluation of findings. Materiality as it relates to giving an opinion on the auditee's compliance is discussed in paragraphs 6.13 through 6.16. The auditor's evaluation of the effect of questioned costs on the compliance opinion is discussed in paragraph 6.55.

Financial Statement Impact

6.53 The auditor also has the responsibility of assessing the impact of the actual and projected error noted in the single audit against the materiality level established for the basic financial statements (see paragraph 6.16). The auditor should consider the effect of (a) any contingent liability that may arise from the noncompliance in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and (b) for nongovernmental entities, any uncertainty regarding the resolution of instances of noncompliance in accordance with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Questioned Costs

6.54 Questioned costs are defined by Circular A-133 to include costs that are questioned by the auditor because of an audit finding (a) that resulted from a violation or possible violation of a provision of a law, regulation contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds, (b) for which the costs, at the time of the audit, are not supported by adequate documentation, or (c) for which the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Evaluating the Effect of Questioned Costs on the Compliance Opinion

6.55 In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of the total costs questioned for each major program (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). There may be instances in which the known questioned costs are not considered material but the likely questioned costs are considered material. In this situation, the auditor should consider the noncompliance to be material or may expand the scope of the audit and apply additional audit procedures to further establish the likely questioned costs. For example, if an auditor's sample results in known questioned costs related to three sample items out of thirty selected, the three errors may not be considered material. However, the auditor's projection of those errors to the entire population may suggest that there are likely questioned costs that are material. In this example, the auditor should consider the noncompliance to be material and should report a finding or expand the scope of the audit and apply additional audit procedures.

Federal Agency Consideration of Findings and Questioned Costs

6.56 The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal awarding agency or pass-through entity will ultimately disallow a questioned cost, because the agency or entity has considerable discretion in these matters.

6.57 Circular A-133 defines a management decision as the evaluation by the federal awarding agency or pass-through entity of the audit findings and corrective action plan (see paragraphs 2.26 and 10.68 through 10.70 for a further discussion of the corrective action plan) and the issuance of a written decision as to what corrective action is necessary. Circular A-133 allows a federal awarding agency or pass-through entity receiving an auditor's report indicating findings and questioned costs six months after receipt of the audit report to issue such a decision. The nature of the questioned costs, as well as the amounts involved, are considered by the awarding agency or pass-through entity in issuing a management decision and deciding whether to disallow them. In addition, most federal awarding agencies have established appeal and adjudication procedures for questioned costs. Because of the discretion allowed in resolving these matters, all questioned costs are subject to uncertainty regarding their resolution.

Reporting the Findings

6.58 Circular A-133 requires the auditor to consider a different level of materiality for the purposes of reporting audit findings (see paragraphs 3.38

through 3.40 for a further discussion). Circular A-133 requires the auditor, in addition to providing an opinion on compliance, to include the following items, among other things, in the schedule of findings and questioned costs (see paragraph 10.56 for a complete listing of the items that are required to be included):

- Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*.
- Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program (see paragraph 6.22 for a listing of the fourteen types of compliance requirements). Known questioned costs are those specifically identified by the auditor.
- Known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement.
- Known questioned costs that are greater than \$10,000 for a federal program that is not audited as a major program (see paragraph 10.63 for a further discussion).

The reporting of findings is discussed in greater detail in paragraphs 10.63 and 10.64.

Reporting the Likely Questioned Costs

6.59 As noted before, in evaluating the effect of questioned costs on the opinion on compliance, the auditor considers both known questioned costs and the best estimate of the total costs questioned (likely questioned costs) for each major program. Known and likely questioned costs also need to be considered when audit findings are reported. In addition to reporting known questioned costs greater than \$10,000 in the schedule of findings and questioned costs, the auditor is also required to report known questioned costs when likely questioned costs are greater than \$10,000. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, the auditor estimates that the total questioned costs are in the \$50,000–\$60,000 range, the auditor would report a finding that indicates the known questioned costs of \$7,000. See paragraph 10.63 for a further discussion.

Findings That Cannot Be Quantified

6.60 The auditor may discover instances of noncompliance that cannot be quantified. The auditor's responsibility for reporting such findings can best be described through an example. Assume that the auditor encounters a pass-through entity that consistently fails to provide its subrecipients with federal award information. Circular A-133 requires the auditor to consider all findings in relation to a type of compliance requirement (in the example provided, subrecipient monitoring is the relevant type of compliance requirement) or an audit objective identified in the *Compliance Supplement*. The pertinent audit objective included in the *Compliance Supplement* and relating to the example provided here is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient." Because the pass-through entity failed to provide federal award

information to its subrecipients, this noncompliance would be material in relation to the audit objective and, therefore, should be reported as an audit finding. In addition, the auditor should also consider whether reportable conditions exist and require reporting with respect to subrecipient monitoring.

Performing Follow-Up Procedures

Auditee Responsibilities for Audit Follow-Up and for the Summary Schedule of Prior Audit Findings

6.61 Circular A-133 states that the auditee is responsible for follow-up and corrective action on all audit findings. The follow-up required by Circular A-133 is facilitated by the requirement that the auditee prepare a summary schedule of prior audit findings (see paragraphs 2.21 and 10.68). This schedule reports the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It also includes audit findings reported in the prior audit's summary schedule of prior audit findings that were not identified as either (1) fully corrected, (2) no longer valid, or (3) not warranting further actions. Circular A-133 states that a valid reason for considering an audit finding as not warranting further action is that *all* of the following have occurred:

- Two years have passed since the audit report in which the finding occurred was submitted to the federal clearinghouse.
- The federal agency or pass-through entity is not currently following up with the auditee on the audit finding.
- A management decision was not issued.

6.62 Circular A-133 also states the following with regard to the auditee's schedule of prior audit findings:

- When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- When audit findings were not fully corrected or were only partially corrected, the summary schedule must describe the planned corrective action as well as any partial corrective action taken.
- When the corrective action taken is significantly different from the corrective action previously reported in a corrective action plan or in the federal agency's or pass-through entity's management decision, the summary schedule must provide an explanation.
- When the auditee believes the audit findings are no longer valid or do not warrant further actions, the reasons for this position must be described in the summary schedule (see paragraph 6.61).

Auditor Responsibilities for Follow-Up on Previously Reported Findings

6.63 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor should also perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year. The auditor's reporting responsibilities are further discussed in chapter 10.

Auditor Follow-Up Procedures

6.64 To follow up on previous audit findings, the auditor should obtain the auditee's summary schedule of prior audit findings and should review its contents with appropriate members of management. Although in many cases the procedures performed in the current audit will provide a basis for the auditor to assess the schedule, the auditor may find it necessary to perform procedures directed specifically at the status of prior audit findings. In these cases, the following procedures are to be considered:

- Inquiry of auditee management and program personnel
- Review of management decisions issued by federal awarding agencies or pass-through entities to the auditee (see paragraph 6.57)
- Observation of an activity that has been redesigned to address a prior-year finding
- Testing of similar current-year transactions

Audit Follow-Up for Findings Reported, as Required by Government Auditing Standards

6.65 As noted in paragraph 3.16, *Government Auditing Standards* establishes an additional fieldwork standard, which requires the auditor to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit to determine whether the auditee has taken timely and appropriate corrective actions. The auditee's schedule of prior audit findings is only required to include the status of prior-year findings relative to federal awards. However, there may be certain financial statement audit findings required to be reported under *Government Auditing Standards* that are included in the summary schedule of prior audit findings (because they also relate to federal awards). Also, although not required, some auditees may decide to include the status of other financial statement audit findings (that is, those that are not related to federal awards) in the schedule. For those financial statement audit findings included in the summary schedule of prior audit findings, the auditor's assessment of the reasonableness of the schedule (described in paragraphs 6.63 and 6.64) would meet the audit follow-up requirements of *Government Auditing Standards*. For financial statement audit findings that are not included in the schedule, the auditor should follow up on the findings to determine their status. See paragraph 10.62 for a discussion of the auditor's responsibility to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

Corrective Action Plan

6.66 Circular A-133 also requires that upon completion of the audit, the auditee prepare a corrective action plan that identifies the contact person responsible for corrective action, indicates the corrective action planned, the anticipated completion date or, if the auditee does not agree with the finding, an explanation and specific reasons why the auditee disagrees. The auditor may find the auditee's corrective action plan useful in performing audit follow-up (in addition to the auditee's summary schedule of prior audit findings) because it may provide a preliminary indication of the corrective steps planned by the auditee.

Disputes or Unresolved Findings

6.67 There may be times when, as part of the follow-up on prior findings, the auditor determines that (a) a previous finding is the subject of a dispute

between the auditee and the federal awarding agency or pass-through entity or (b) the federal awarding agency or pass-through entity has not addressed the finding by issuing a management decision. In these situations, if the finding relates to a current-year major program, the auditor should report similar transactions of the current year as findings and questioned costs until either the dispute is resolved or the initial finding no longer warrants further action under Circular A-133 as described in paragraph 6.61. However, if the auditor no longer believes that there is noncompliance because of additional evidence obtained in the current year, similar transactions need not be reported as findings.

Management Representations Related to Federal Awards

6.68 As part of an audit under Circular A-133, the auditor should obtain written representations from management about matters related to federal awards. Therefore, in addition to the management representations obtained in connection with an audit of the financial statements as discussed in paragraph 4.40, the auditor should obtain written representations from management concerning the identification and completeness of federal award programs, representations concerning compliance with compliance requirements, and identification of known instances of noncompliance.

Suggested Representations

6.69 The auditor should consider obtaining the following written representations in a single audit:²

- Management is responsible for complying, and has complied, with the requirements of Circular A-133.
- Management has prepared the schedule of expenditures of federal awards in accordance with Circular A-133 and has included expenditures made during the period being audited for all awards provided by federal agencies in the form of grants, federal cost-reimbursement contracts, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance.
- Management is responsible for complying with the requirements of laws, regulations, and the provisions of contracts and grant agreements related to each of its federal programs.
- Management is responsible for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its federal programs.
- Management has identified and disclosed to the auditor the requirements of laws, regulations and the provisions of contracts and grant agreements that are considered to have a direct and material effect on each federal program.

² These representations may be added to a representation letter obtained in connection with an audit of the financial statements instead of a separate letter.

- Management has made available all contracts and grant agreements (including amendments, if any) and any other correspondence that have taken place with federal agencies or pass-through entities and are related to federal programs.
- Management has complied, in all material respects, with the compliance requirements in connection with federal awards except as disclosed to the auditor.
- Management has identified and disclosed to the auditor all amounts questioned and any known noncompliance with the requirements of federal awards, including the results of other audits or program reviews.
- Management's interpretations of any compliance requirements that have varying interpretations have been provided.
- Management has made available all documentation related to the compliance requirements, including information related to federal program financial reports and claims for advances and reimbursements.
- Federal program financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared, and are prepared on a basis consistent with that presented in the schedule of expenditures of federal awards.
- The copies of federal program financial reports provided to the auditor are true copies of the reports submitted, or electronically transmitted, to the federal agency or pass-through entity, as applicable.
- If applicable, management has monitored subrecipients to determine that they have expended pass-through assistance in accordance with applicable laws and regulations and has met the requirements of Circular A-133.
- If applicable, management has issued management decisions on a timely basis after their receipt of subrecipients' auditor's reports that identified noncompliance with laws, regulations, or the provisions of contracts or grant agreements, and has ensured that subrecipients have taken the appropriate and timely corrective action on findings.
- If applicable, management has considered the results of subrecipient audits and has made any necessary adjustments to their own books and records.
- Management is responsible for and has accurately prepared the summary schedule of prior audit findings to include all findings required to be included by Circular A-133.
- Management has provided the auditor with all information on the status of the follow-up on prior audit findings by federal awarding agencies and pass-through entities, including all management decisions.
- Management has accurately completed the appropriate sections of the data collection form.
- If applicable, management has disclosed all contracts or other agreements with the service organizations.
- If applicable, management has disclosed to the auditor all communications from the service organization relating to noncompliance at the service organization.
- Management has disclosed any known noncompliance occurring subsequent to the period for which compliance is audited.

- Management has disclosed whether any changes in internal control over compliance or other factors that might significantly affect internal control, including any corrective action taken by management with regard to reportable conditions (including material weaknesses), have occurred subsequent to the date as of which compliance is audited.

Refusal to Furnish Written Representation

6.70 Management's refusal to furnish all written representations that the auditor considers necessary in the circumstances constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the auditee's compliance with major program requirements. The auditor should also consider the effects of management's refusal on his or her ability to rely on other management representations.

State and Local Government Compliance Auditing Considerations

6.71 An auditor may also be engaged to test and report on compliance with state and local laws and regulations in addition to the testing and reporting requirements imposed by *Government Auditing Standards* and Circular A-133. Although such auditing is outside the scope of this SOP, such a requirement may specify compliance tests, similar to those in a single audit. When this is the case, auditors should consult state or local government officials or other sources concerning the nature and scope of the required testing. However, state or local government funds should be distinguished from pass-through federal funds. When a single audit is conducted, pass-through federal funds are considered part of the federal awards received. See paragraphs 3.49 through 3.51 for a brief discussion of state and local compliance requirements.

Chapter 7

DETERMINATION OF MAJOR PROGRAMS

7.1 As noted in paragraph 2.22, Circular A-133 requires the auditee to identify in its accounts all federal awards received and expended and the federal programs under which they were received. The auditee is also required to prepare a schedule of expenditures of federal awards for the period covered by its financial statements (see chapter 5 for a further discussion of the requirements related to this schedule). However, Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides the criteria to be used in applying a risk-based approach to determining major programs. The risk-based approach is designed to focus the single audit on higher-risk programs. See paragraph 7.20 for a description of when the auditor can deviate from the use of risk criteria.

7.2 The auditor's determination of the programs to be audited is based on an evaluation of the risk of noncompliance occurring that could be material to an individual major federal program. In evaluating such risk, the auditor considers, among other things, the current and prior audit experience with the auditee, the oversight exercised by federal agencies and pass-through entities, and the inherent risk of the federal programs. The auditor should use professional judgment and the guidance in sections 520, 525, and 530 of Circular A-133 in the risk assessment process. In addition, the auditor should consider the need to discuss the nature of federal programs with the management of the auditee and of the federal or state agency that provided the funds to the auditee.

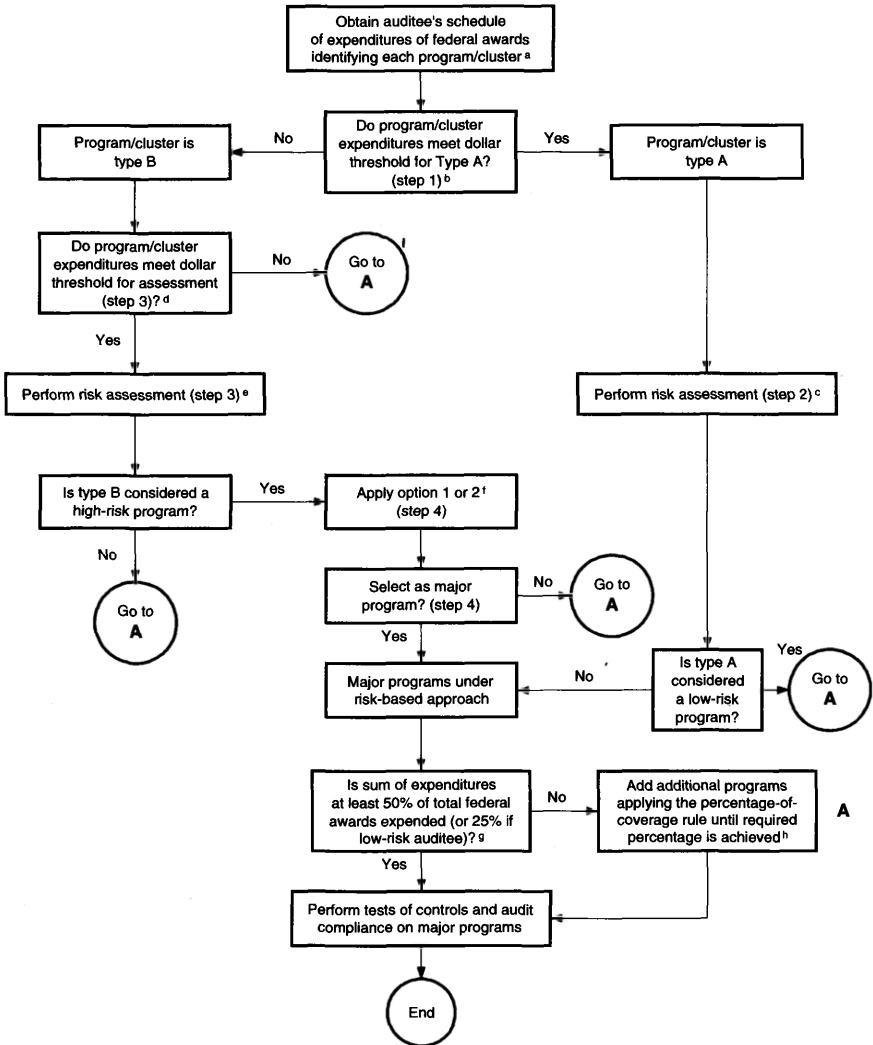
Applying the Risk-Based Approach

7.3 The guidance on the risk-based approach is organized here as provided in Circular A-133 and consists of the following steps (see table 7.1 for a flowchart illustration of applying the risk-based approach for determining major programs):

- Step 1—determination of type A and type B programs (paragraphs 7.4 through 7.9)
- Step 2—identification of low-risk type A programs (paragraphs 7.10 through 7.13)
- Step 3—identification of high-risk type B programs (paragraphs 7.14 through 7.16)
- Step 4—determination of programs to be audited as major (paragraphs 7.17 through 7.20)

Exhibit 7.1

Flowchart Illustration of Applying the Risk-Based Approach for Determining Major Programs



- a. See paragraph 1.18 for the definition of federal programs, including clusters.
- b. See paragraphs 7.4 through 7.9 for a detailed discussion of step 1.
- c. See paragraphs 7.10 through 7.13 for a detailed discussion of step 2.
- d. See paragraphs 7.14 through 7.16 for a detailed discussion of step 3.
- e. Before performing the risk assessment, the auditor should consider whether option 1 or option 2 will be selected under step 4 because it will affect whether risk assessments need to be performed on all type B programs or only some type B programs. See paragraph 7.15.
- f. The number of type B high-risk programs identified as major programs is either—
 - *Option 1:* one-half of the number of type B high-risk programs, unless this number exceeds the number of low-risk type A programs identified in step 2. In this case, the auditor would be required to audit as major the same number of high-risk type B programs as low-risk type A programs. Under this option, the auditor is expected to perform risk assessments on all type B programs that exceed the threshold for type B.
 - *Option 2:* one high-risk program for each low-risk type A program. This option does not require the auditor to perform risk assessments on all type B programs. See paragraphs 7.17 through 7.20 for a detailed discussion of step 4, including option 1 and option 2.
- g. There may be instances when the auditee includes certain noncash assistance (such as loan guarantees or loans) in the notes to the schedule of expenditures of federal awards (see paragraph 5.13). The auditor should be sure to include such noncash assistance as part of total federal awards expended when performing this calculation.
- h. The additional programs/clusters selected (marked “A” on the flowchart) to meet the percentage-of-coverage rule are audited as major programs in addition to type A and type B programs identified in steps 1 through 4. See paragraph 7.24 for a further discussion of the percentage-of-coverage rule.

Step 1—Determination of Type A and Type B Programs

7.4 To determine which federal programs are to be audited as major (see step 4), the auditor must first identify federal programs as being either type A or type B as defined in Circular A-133. In general, type A programs are larger federal programs and type B programs are smaller federal programs. The auditor should obtain the schedule of expenditures of federal awards from the auditee to assist in the identification of type A and type B programs. The schedule of expenditures of federal awards, prepared by the auditee, includes all cash and noncash awards either on the face of the schedule or in the notes to the schedule. Auditors should note that for purposes of determining major programs, a cluster of programs should be considered as one program (see paragraphs 1.18, 1.19, 2.18, 5.6, and 8.30 for a further discussion of a cluster of programs).

Type A Program Criteria

7.5 The larger federal programs are labeled as type A. The criteria that Circular A-133 establishes for identifying Type A programs are presented in table 7.1.

Table 7.1

Criteria for Identifying Type A Programs

<i>When Total Federal Awards Expended* Are—</i>	<i>A Type A Program Is Any Program With Federal Awards Expended That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to, \$100 million	\$300,000 or 3% (0.03) of federal awards expended
More than \$100 million and less than or equal to \$10 billion	\$3 million or 0.3% (0.003) of federal awards expended
More than \$10 billion	\$30 million or 0.15% (0.0015) of federal awards expended

* Includes both cash and noncash awards.

Type B Program Criteria

7.6 Federal programs that do not meet the type A criteria are considered type B programs.

Effect of Large Loans and Loan Guarantees on Identification of Type A Programs

7.7 The various types of noncash awards, including loans and loan guarantees, and how they are valued are discussed in chapter 5. Circular A-133 states that when the auditor applies the dollar criteria shown in table 7.1 to identify type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as type A programs. Auditors should note that this requirement relates only to loans and loan guarantees and not to any other large noncash awards. When a federal program providing loans or loan guarantees *significantly affects* the number or size of type A programs, the auditor should consider the loan or loan guarantee program a type A program and exclude its values in determining other type A programs. The auditor should use professional judgment in determining whether type A programs would be *significantly* affected in this situation.

7.8 The example in table 7.2 demonstrates this concept by showing the identification of type A programs as well as the effect of loans and loan guarantees on that identification process.

Table 7.2

**Identification of Type A Programs and the Effect
of Loans and Loan Guarantees**

<i>Program / Federal Grantor</i>	<i>Federal Awards Expended (\$000)</i>
Cash program A—U.S. Department of Labor	\$ 1,335
Cash program B—U.S. Department of Health and Human Services	3,000
Cash program C-1—U.S. Department of Education	175
Cash program C-2—U.S. Department of Education	280
Cash program D—U.S. Department of Housing and Urban Development (a pass-through grant from a local government)	310
Subtotal—cash federal awards expended	\$ 5,100
Commodities program E—U.S. Department of Agriculture (a pass- through grant from a state)	2,000
Subtotal—cash and commodities federal awards expended	\$ 7,100
Loan program F—U.S. Department of Housing and Urban Development	33,500*
Loan guarantee program G—U.S. Department of Agriculture	57,000*
Total federal awards expended	\$97,600

* In accordance with Circular A-133, loans and loan guarantees include new loans made during the year, plus prior-year loans for which the federal government imposes continuing compliance requirements, plus any interest subsidy, cash, or administrative cost allowance received. See paragraphs 5.14 and 5.15 for additional information.

7.9 In table 7.2 the auditee has \$97,600,000 in total federal awards expended. Therefore, an application of the criteria in table 7.1 would indicate that type A programs would be those that expended federal awards equal to or greater than \$2,928,000 (3 percent of \$97,600,000), or programs B, F, and G. However, when large loan and loan guarantee programs F and G are excluded from the base amount of the total federal awards expended in the calculation, the type A programs would be those programs that expended federal awards equal to or greater than \$300,000 (the larger of \$213,000 [3 percent of \$7,100,000], or \$300,000). Therefore, under the second calculation programs A, B, D, E, F, and G would be type A programs. If the auditor, in his or her professional judgment, concludes that the difference in the number or size of type A programs is significantly affected by the inclusion of the loans and loan guarantees (which in this example would be likely due to the significant increase in type A programs), the auditor would identify programs A, B, D, E, F, and G as type A programs. The auditor should consider contacting the cognizant or oversight agency for audit if the auditor is unsure about whether to exclude loan or loan guarantees when determining type A programs.

Step 2—Identification of Low-Risk Type A Programs

7.10 After completing step 1, the auditor should perform a risk assessment of each type A program to identify those that are low-risk. Circular A-133 includes certain conditions that, when met, indicate that a type A program may be low-risk.

General Conditions for Low-Risk Type A Programs

7.11 Type A programs may generally be considered low-risk if both of the following conditions are met: (a) the program has been audited as a major program

in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and (b) in the most recent audit period, the *program* had no audit findings (see paragraph 10.63 for a description of audit findings).

Auditor Judgment in Determination of Low-Risk Type A Programs

7.12 Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low-risk even though (a) in the prior audit period it may have had known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (b) known fraud has been identified, or (c) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. For example, consider a situation in which the funds expended under a federal program in the prior year totaled \$10 million, there were known questioned costs of \$11,000 that related to one isolated instance, and there were no additional likely questioned costs. In this example, the auditor, based on professional judgment, could decide that the program is low-risk in the current year. In making the final determination of whether a type A program is low-risk, the auditor should also consider the risk criteria in paragraphs 7.26 through 7.36, the results of audit follow-up, and whether any changes in the personnel or systems affecting a type A program have significantly increased its risk. Based on all of this information, the auditor would apply professional judgment in determining whether a type A program is low-risk.

Type A Program Not Considered Low-Risk at Request of Federal Awarding Agency

7.13 A federal awarding agency may request that a type A program for certain recipients not be considered low-risk so that it would be audited as a major program. For example, it may be necessary for a large type A program to be audited as major each year for particular recipients, to allow the federal agency to comply with the Government Management Reform Act of 1994. In this instance, Circular A-133 requires the federal awarding agency to obtain approval from the OMB. Furthermore, the federal awarding agency must notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year end to be audited. (See also paragraph 7.35 for a discussion of the federal agency or pass-through entity option to identify federal programs as higher risk in the *Compliance Supplement*.)

Step 3—Identification of High-Risk Type B Programs

7.14 After completing steps 1 and 2, the auditor should identify type B programs that are high-risk, using professional judgment and the risk criteria discussed in paragraphs 7.26 through 7.36. Except for known reportable conditions in internal control or instances of noncompliance, a single risk criteria would, in general, seldom cause a type B program to be considered high-risk.

7.15 Before beginning step 3, the auditor should—

- a. Consider whether there are low-risk type A programs. When there are no type A programs identified as low-risk (either because there are no type A programs or because none of the type A programs are low-risk), the auditor is not required to perform step 3. Instead, the auditor would audit as major enough type B programs to meet the

percentage-of-coverage rule (see paragraph 7.24). When there are type A programs, but none are low-risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule. In either case, any programs requested to be audited by a federal agency or pass-through entity must be audited as a major program and would be included in determining whether the percentage-of-coverage rule has been met (see paragraph 7.21).

- b. Consider whether option 1 or option 2 will be used in step 4 (see paragraphs 7.18 through 7.19 for a detailed description of each option). The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. The auditor should consider the following discussion before deciding whether to use option 1 or option 2.
 - Under option 1, the auditor is required to perform a risk assessment on all type B programs (excluding small type B programs as discussed in paragraph 7.16). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Also assume that the auditor chooses option 1. In this scenario, the auditor would be required to perform a risk assessment on all type B programs. If the auditor finds that only four type B programs are high-risk, the auditor would only be required to audit two of the four high-risk type B programs as major (one-half of the number of high-risk type B programs).
 - Under option 2, the auditor is only required to identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Assume also that the first four type B programs subject to risk assessment are determined by the auditor to be high-risk. In this scenario, the auditor may choose option 2, identify the four high-risk type B programs as major, and not perform risk assessments on the remaining six type B programs. Using the same example but assuming that the auditee only has one low-risk type A program (instead of four), the auditor would be required to audit one type B program as major under either option 1 or 2. In this scenario, option 2 would likely be the most efficient choice for the auditor since the auditor would only need to perform type B program risk assessments until one high-risk type B program was identified (under option 1 the auditor would be required to perform a risk assessment on all type B programs).

Criteria for Performing Risk Assessments on Type B Programs

7.16 An auditor is not expected to perform risk assessments on relatively small federal programs. Therefore, Circular A-133 only requires the auditor to

perform risk assessments on type B programs that exceed the larger of the criteria shown in table 7.3.

Table 7.3

Criteria for Performing Risk Assessments on Type B Programs

<i>When Total Federal Awards Expended* Are—</i>	<i>Perform Risk Assessment for Type B Programs That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to \$100 million	\$100,000 or 0.3% (0.003) of federal awards expended
More than \$100 million	\$300,000 or 0.03% (0.0003) of federal awards expended

* Includes both cash and noncash awards.

Step 4—Determination of Programs to Be Audited as Major

Criteria for Major Programs

7.17 After completing steps 1 through 3, the auditor identifies the major programs. At a minimum, Circular A-133 requires the auditor to audit all of the following as major programs:

- All type A programs, except those identified as low-risk under step 2 (see paragraphs 7.10 through 7.13)
- High-risk type B programs as identified under either of the two options described in paragraph 7.18
- Programs to be audited as major based on a federal agency request (in lieu of the federal agency conducting or arranging for additional audits; see paragraph 7.21 for further information)
- Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described in paragraph 7.24

Two Options Available for Identifying High-Risk Type B Programs

7.18 Section 520(e)(2) of Circular A-133 provides two options for identifying high-risk type B programs:

- *Option 1.* Under option 1, the auditor is expected to perform risk assessments of all type B programs that exceed the amount specified in table 7.3, and to audit at least one-half of the high-risk type B programs as major, unless this number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap. For example, consider an auditee that has ten low-risk type A programs, and fifty type B programs above the amount specified in table 7.3. Under this option, the auditor would be required to perform risk assessments of the fifty type B programs. Assume that based on that assessment, the auditor determines that there are twenty-five high-risk type B programs. One-half of the twenty-five high-risk type B programs is 12.5, which rounds up to thirteen programs. Under this option, the auditor would audit thirteen of the high-risk type B programs as major; however, since the cap in this example is ten (that is, the number of low-risk type A programs), the auditor is only required to audit ten high-risk type B programs as major.

- **Option 2.** Under option 2, the auditor is only required to audit as major one high-risk type B program for each type A program identified as low-risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero). Continuing with the previous example, under option 2 the auditor would perform risk assessments of type B programs until ten high-risk programs are identified (that is, ten is the number of low-risk type A programs). The auditor would then audit as major the ten type B programs identified as high-risk. Depending on the order in which risk assessments on type B programs are performed, the auditor might only need to perform risk assessments of ten type B programs determined to be high-risk, or the auditor may need to perform risk assessments on additional Type B programs until ten high-risk programs are identified.

7.19 The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs (see paragraph 7.15). Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Deviation From Use of Risk Criteria

7.20 For first-year audits, Circular A-133 allows auditors to deviate from the above-described risk assessment process. A first-year audit is defined as the first year an entity is audited under the June 30, 1997, revision to Circular A-133 or as the first year of a change in auditors. This exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in paragraph 7.24. Under this option, the auditor is not required to perform steps 2, 3, and 4. However, to ensure that a frequent change of auditors would not preclude the audit of high-risk type B programs, this election for first-year audits may not be used more than once every three years. Auditors should consider whether this exception is an option during the planning phase of the single audit (see also paragraphs 3.30 and 3.31 for a discussion of initial-year audit considerations).

Other Considerations Regarding the Risk-Based Approach

Federal Agency Requests for Additional Major Programs

7.21 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if it would not, informing the agency of the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major

program based on the federal agency's request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Documentation of Risk Assessment in the Working Papers

7.22 Circular A-133 requires the auditor to document in the working papers the risk assessment process used in determining major programs. It is therefore necessary for the auditor to document adequately, as required by GAAS and *Government Auditing Standards*, the determination of major programs (see the discussion of working paper requirements in paragraphs 3.20 through 3.22 and 3.24 through 3.25).

Auditor Judgment in the Risk Assessment Process

7.23 Circular A-133 states that when the determination of major programs is performed and documented by the auditor in accordance with the circular, the auditor's judgment in applying the risk-based approach to determine major programs is presumed correct. Challenges by federal agencies and pass-through entities should only be made for clearly improper use of the guidance in Circular A-133. It should be noted, however, that federal agencies and pass-through entities may provide the auditor with guidance about the risk of a particular federal program, which the auditor should consider when determining major programs.

Percentage-of-Coverage Rule

7.24 Circular A-133 requires the auditor to audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended. However, if the auditee meets the criteria for a low-risk auditee (see paragraph 7.25), the auditor is only required to audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. To comply with this requirement, the auditor should compute the total federal awards expended for the major programs, determined under step 4, as a percentage of the total federal awards expended. If the total does not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal 50 percent (or 25 percent in the case of a low-risk auditee) and test them as major programs. The selection of additional programs to meet the percentage of coverage is based on the auditor's professional judgment. When selecting additional programs to meet the percentage-of-coverage rule, the auditor may select programs without regard to risk assessment. If loans or loan guarantees are major programs, these programs may be used for purposes of meeting the percentage-of-coverage rule. Furthermore, when a federal agency or pass-through entity requests and pays for a program to be audited as major (see paragraph 7.21), that program may also be used for purposes of meeting the percentage-of-coverage rule.

Low-Risk Auditee Criteria

7.25 Circular A-133 establishes certain conditions for determining whether an auditee is low-risk. An auditee that meets all of the following conditions

for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for the reduced audit coverage discussed in paragraph 7.24:

- a. Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- b. The auditor's opinions on the financial statements and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.
- c. There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.
- d. None of the federal programs had audit findings from any of the following in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) in which they were classified as type A programs:
 - Material weaknesses in the internal control over compliance
 - Noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program
 - Known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year

Criteria for Federal Program Risk

7.26 The auditor's risk assessment should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the federal program being evaluated. Circular A-133 indicates that the auditor should use professional judgment and consider certain criteria to identify risk in federal programs. As a part of the risk assessment, the auditor may also wish to discuss a particular federal program with auditee management and with the federal agency or pass-through entity. The criteria for federal program risk that are identified in Circular A-133 are discussed in the following sections.

Current and Prior Audit Experience

7.27 The auditor should consider his or her prior experience with the auditee and the results of audits performed in the past. The following specific factors that should be considered:

- Weaknesses in the internal control over compliance for federal programs (paragraph 7.28)
- Federal programs administered under multiple internal control structures (paragraph 7.29)

- A weak system for monitoring subrecipients when significant parts of federal programs are passed through to subrecipients (paragraph 7.30)
- The extent to which computer processing is used (paragraph 7.31)
- Prior audit findings (paragraph 7.32)
- Federal programs not recently audited as major (paragraph 7.33)

Weaknesses in Internal Control Over Federal Programs

7.28 In assessing program risk, the auditor should consider internal control over compliance for federal programs (see chapter 8 for detailed guidance on internal control over compliance for federal programs). Weak internal control over compliance for federal programs is an indication of higher risk. Consideration should also be given to the control environment over federal programs and to such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements. The auditor may also consider the competence and experience of the personnel who administer federal programs. In instances in which the staff are new or do not have experience with a program, consideration should be given to assessing the program at a higher level of risk.

Federal Programs Administered Under Multiple Internal Control Structures

7.29 Federal programs administered by multiple internal control structures may have a higher risk. This often occurs when multiple operating units are involved in the administration of federal programs. An example of this would be a university that has several campuses administering a federal program. When assessing risk, the auditor should consider whether any internal control weaknesses are isolated in a single operating unit (that is, one college campus) or are pervasive throughout the entity. If the identified weaknesses are isolated, and absent other weaknesses, the auditor could still potentially reach the conclusion that the program is low-risk. The final determination would be based on the auditor's judgment.

Weak System for Monitoring Subrecipients

7.30 Consideration should be given to the extent that federal programs are passed through to subrecipients. If the auditee passes a significant portion of a federal program to subrecipients and the auditor has identified that the auditee has a weak system for monitoring subrecipients, the auditor should consider assigning a higher risk to the program. Alternatively, if the auditee passes a significant portion of programs to subrecipients and the auditee has an effective system in place to monitor the subrecipients, the auditor should consider assigning a lower level of risk to the program.

Extent to Which Computer Processing Is Used

7.31 When assessing risk, the auditor should consider the extent to which computer processing is used to administer federal programs, as well as the complexity of that processing. A complex system does not always indicate higher risk. On the other hand, a newly installed system that has not been tested in the past, or a recently modified system, may indicate higher risk. Auditors should refer to SAS No. 31, *Evidential Matter*, as amended by SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements*, and SAS No. 80, *Amendment to SAS No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), and SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS. No. 78,

Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55, and SAS No. 94, The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 319), for guidance when significant auditee information is transmitted, processed, maintained, or accessed electronically.

Prior Audit Findings

7.32 As a part of the risk assessment, the auditor should consider prior audit findings. These findings may be the result of previous single audits by independent auditors or of compliance or financial audits performed by internal auditors or government auditors in conjunction with the federal awarding agency's monitoring activities. The auditor should consider assessing a higher risk for programs for which prior audit findings have a significant impact on a federal program or for which no corrective action has been implemented since the findings were identified.

Federal Programs Not Recently Audited as Major

7.33 Federal programs that have not recently been audited as major programs may be of higher risk than federal programs recently audited as major. For example, many type B programs may never have been audited as major programs in the past. A higher level of risk would likely be assessed on such programs than on those programs that have been consistently audited as major programs without audit findings.

Oversight Exercised by Federal Agencies and Pass-Through Entities

7.34 The oversight exercised by federal agencies or pass-through entities could indicate risk. An important factor in assessing risk is the results of recent audits performed by federal agencies or pass-through entities. For example, recent monitoring or other reviews that were performed by an oversight entity and that disclosed no audit findings may indicate lower risk, whereas monitoring that disclosed significant findings could indicate higher risk. However, the auditor should understand the scope of the review that was performed. Reviews performed by federal agencies or pass-through entities vary widely as to coverage and intensity.

7.35 Circular A-133 states that federal agencies, with the concurrence of the OMB, may identify federal programs that are high-risk. This identification will be provided by the OMB in the *Compliance Supplement*. For example, the U.S. Department of Health and Human Services has identified the Medicaid Assistance Program as a program of higher risk in the *Compliance Supplement*. Although such an identification by a federal agency does not preclude an auditor from determining that a program is low-risk (for example, because prior audits have shown strong internal control and compliance), the auditor should consider it as part of the risk assessment process.

Inherent Risk of the Federal Programs

7.36 As part of the risk assessment, the auditor needs to consider the inherent risk of federal programs. Inherent risk is the risk that material noncompliance with requirements applicable to a major program could occur, assuming there is no related internal control. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides examples of program characteristics with potentially higher inherent risks; these are discussed in paragraphs 6.8 and 6.9.

Chapter 8

CONSIDERATION OF INTERNAL CONTROL OVER COMPLIANCE FOR MAJOR PROGRAMS

8.1 Circular A-133 establishes requirements for additional audit procedures and reporting relative to the auditor's consideration of internal control over compliance for major programs. These requirements are beyond those of a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards*. The auditor's consideration of internal control over financial reporting is discussed in chapter 4. In this chapter, the additional considerations of internal control over compliance for major programs are discussed. The reporting on internal control over compliance for major programs is discussed in paragraph 8.3 and chapter 10.

Summary of Circular A-133 Requirements Related to Internal Control Over Compliance for Federal Programs

Auditee Responsibilities

8.2 Circular A-133 requires the auditee to maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs.

Auditor Responsibilities

8.3 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to—

- Perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- Plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform testing of the internal control over compliance as planned.
- Report on internal control over compliance describing the scope of the testing of internal control and the results of the tests and, where applicable, referring to the separate schedule of findings and questioned costs. This schedule includes, where applicable, a statement that reportable conditions in internal control over compliance for major programs were disclosed by the audit and whether any such conditions were material weaknesses.

Auditor Responsibility for Internal Control Over Compliance for Programs That Are Not Major

8.4 The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control over compliance for programs that are not considered major, or to plan or perform any related testing of internal control over compliance for those programs except for any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs (see chapter 7). However, the auditor should note that a program that is not considered major could still be material to the financial statements. In this situation, in conjunction with the financial statement audit, the auditor may need to obtain an understanding of the internal control over financial reporting that is relative to the program. The auditor's consideration of internal control over financial reporting is discussed in chapter 4.

Circular A-133 Definition of Internal Control Over Federal Programs

8.5 Circular A-133 defines internal control over federal programs as follows.

Internal control pertaining to the compliance requirements for federal programs (*Internal control over federal programs*) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for federal programs:

1. Transactions are properly recorded and accounted for to:
 - a. Permit the preparation of reliable financial statements and federal reports;
 - b. Maintain accountability over assets; and
 - c. Demonstrate compliance with laws, regulations, and other compliance requirements;
2. Transactions are executed in compliance with:
 - a. Laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
 - b. Any other laws and regulations that are identified in the compliance supplement; and
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Control Objectives

8.6 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319.06) states that there are three categories of internal control: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others regarding each separate purpose. For purposes of this SOP, controls relevant to the audit of the financial statements are referred to as "internal control over financial reporting" and are encompassed in the report

on internal control over financial reporting that is required by Government Auditing Standards (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP “as internal control over compliance” and are encompassed in the report on internal control over compliance required by Circular A-133 (see paragraphs 10.46 through 10.49). See paragraphs 4.11 and 4.12 for a more detailed discussion.

Auditor’s Consideration of Internal Control Over Compliance for Each Major Program

8.7 The auditor’s consideration of internal control over compliance for each major program is similar to the consideration of internal control over financial reporting in a financial statement audit as described in SAS No. 55, as amended. In his or her consideration of internal control over compliance, the auditor—

- Obtains an understanding of internal control over compliance for federal programs that is sufficient to plan the audit, by performing procedures to understand (a) the design of controls relevant to the compliance requirements for each major program and (b) whether they have been placed in operation (note that although Circular A-133 requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, it does not actually require the achievement of a low assessed level of control risk).
- Assesses control risk for the assertions relevant to the compliance requirements for each major program. The auditor uses the knowledge provided by the understanding of internal control over compliance and the assessed level of control risk to determine the nature, timing, and extent of substantive tests for assertions relevant to the compliance requirements for each major program. Compliance auditing is discussed in chapter 6.

8.8 An understanding of the internal control over compliance and an assessment of control risk may be performed concurrently in an audit. Similarly, based on the assessed level of control risk that the auditor expects to support and on audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining an understanding of controls.

Obtaining an Understanding of Internal Control Over Compliance for Major Programs

Understanding Compliance Assertions and Identifying Relevant Controls

8.9 As noted in paragraph 8.3, the auditor is required to perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed

level of control risk for major programs. The determination of major programs is discussed in chapter 7. The auditor needs to understand the assertions relevant to the compliance requirements for each major program. Those assertions will determine the types of controls the auditor needs to consider in a single audit. In identifying controls relevant to specific assertions, the auditor should consider that the controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion depending on the nature of the particular internal control component involved. An entity generally also has controls relating to objectives that are not relevant to specific assertions and that therefore need not be considered in a Circular A-133 audit.

8.10 In obtaining an understanding of controls, the auditor should consider the guidance in paragraphs 41 through 43 of SAS No. 55, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 319.41–43). This includes performing procedures to provide sufficient knowledge of both the design of the relevant controls pertaining to each of the five internal control components (that is, control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation. The auditor ordinarily obtains this knowledge through previous experience with the entity and through such procedures as inquiries of appropriate management, supervisory, and staff personnel; an inspection of the entity's documents and records; and his or her observation of the entity's activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

8.11 Entities may use the same controls for more than one federal program and for similar transactions (for example, cash disbursements). Accordingly, those controls will often provide assurance regarding the achievement of the compliance objectives related to some or all federal program transactions and assets.

OMB Compliance Supplement *Internal Control Guidance*

8.12 When determining the assertions relevant to the compliance requirements for each major program of the entity, the auditor should consider referring to the discussion on internal control found in part 6 of the *Compliance Supplement*. The *Compliance Supplement* provides a general discussion of the control objectives, components, and activities that are likely to apply to the fourteen types of compliance requirements (see the discussion of the types of compliance requirements in paragraph 6.22). This guidance is not a checklist of required internal control characteristics; it is intended, instead, to assist the auditor in planning and performing the single audit. However, the auditee is responsible for designing and implementing internal control that is sufficient to provide reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. Control activities beyond those discussed in the *Compliance Supplement* may need to be designed and implemented by the auditee to meet this responsibility. Similarly, the auditor is responsible for evaluating internal control over compliance, to plan the audit to support a low assessed level of control risk for each major program. The auditor may need to perform tests of internal control

over compliance that are related to control objectives and activities in addition to those discussed in the *Compliance Supplement*.

Multiple-Component Considerations

8.13 Federal programs are often administered by several organizational components within an auditee. Each component may maintain separate internal control over compliance that is relevant to the programs, or parts of the programs, that the component administers. In these situations, the auditor should perform procedures to obtain an understanding of the internal control over compliance that is separately maintained by organizational components and that is relevant to each material part of a major program, and should plan and perform testing of those controls as discussed in this chapter (see also paragraphs 6.34 and 7.29 for other multiple-component considerations).

Subrecipient Considerations

8.14 Many entities that are pass-through entities for federal awards make subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The auditor of the pass-through entity has certain considerations related to the entity's internal control over the monitoring of subrecipients. See paragraph 9.23 for a discussion of the audit considerations of federal pass-through awards.

Planning and Performing Testing of Internal Control Over Compliance for Major Programs

Assessing Control Risk

8.15 After obtaining an understanding of internal control over compliance for major programs, the auditor makes a preliminary assessment of control risk for the assertions relevant to the compliance requirements for each major program (see also the related discussion in paragraphs 6.7 through 6.12). Control risk is the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the auditee's internal control over compliance. The assessment of control risk is the process of evaluating the effectiveness of an entity's internal control over compliance in preventing or detecting material noncompliance with the compliance requirements for each major program. In assessing control risk, the auditor should consider the guidance in paragraphs 45 through 57 of SAS No. 55, as amended (AICPA, *Professional Standards*, vol. 1, AU secs. 319.45–57). The auditor should consider the preliminary assessment of control risk when he or she designs the nature and extent of tests of compliance. The Circular A-133 requirement to plan the testing of internal control over compliance to support a low assessed level of control risk is discussed in paragraphs 8.16 through 8.19. The auditor's responsibilities when the internal control over compliance is ineffective in preventing or detecting noncompliance are discussed in paragraphs 8.20 through 8.22.

Planning the Testing of Internal Control Over Compliance for Major Programs to Support a Low Assessed Level of Control Risk

8.16 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs to support a low assessed level of

control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk. A low assessed level of control risk can only be understood in relative terms when it is compared with maximum or moderate levels. Therefore, the auditor exercises professional judgment to determine the procedures necessary to obtain a low level of control risk. The auditor should consider the purpose of the requirement to plan the tests of controls to achieve a low assessed level of control risk (that is, federal agencies want to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with applicable laws and regulations).

8.17 Assessing control risk at below the maximum level involves (a) identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions and (b) performing tests of controls to evaluate the effectiveness of such controls.

8.18 When the auditor assesses control risk at below the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusions to which it leads all bear on the degree of assurance the evidential matter provides. In obtaining evidential matter, the auditor should consider the guidance in paragraphs 64 through 78 of SAS No. 55, as amended (AICPA, *Professional Standards*, vol. 1, AU secs. 319.64–78).

8.19 Paragraph 4.32 of *Government Auditing Standards* provides the following additional guidance related to the assessment of control risk:

- The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.
- Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.
- Inquiries alone generally will not support an assessment that control risk is below the maximum.
- Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.
- Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.

Existence of Ineffective Internal Control in Preventing or Detecting Noncompliance

8.20 When internal control over compliance for some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the auditor is not required to plan and perform tests of internal control over compliance as described in paragraphs 8.3, 8.16, and 8.23. If the internal control over compliance is deemed likely to be ineffective, Circular A-133 requires the auditor to assess control risk at the maximum and consider whether any additional compliance tests are required because of ineffective internal control. The auditor is also required to report a reportable condition (including whether such condition is a material weakness) as part of

the audit findings (see paragraphs 10.46, 10.56, and 10.63 for a discussion of how reportable conditions should be reported).

8.21 The assessment of the effectiveness of internal control over compliance in preventing or detecting noncompliance is determined in relation to each individual type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. For example, controls over requirements for eligibility may be ineffective because of a lack of segregation of duties. In this case, the auditor would be required to—

- Report the lack of segregation of incompatible duties as it relates to eligibility as a reportable condition (note that the reportable condition could be a material weakness).
- Assess the control risk related to requirements for eligibility at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures designed to test compliance with requirements for eligibility of the major program. In most cases, the extent of testing would need to be expanded.

8.22 In planning the tests of controls, the auditor will need to consider the results of tests performed in prior years. If the results of the prior year tests of controls prevented a low level of control risk assessment, the auditor may consider expanded testing in the next audit period. That consideration should include the testing of any changes in internal control over compliance that were intended to eliminate deficiencies noted in the previous year. If, however, the auditee has made no changes to its internal control over compliance, the auditor may determine that controls are not likely to be effective and may choose not to plan and perform tests of controls. In this situation, a reportable condition should be reported (see paragraph 8.20).

Performing Tests to Evaluate the Effectiveness of Controls

8.23 As noted in paragraph 8.3, Circular A-133 requires the auditor to perform testing of internal control over compliance as planned (see paragraphs 8.20 through 8.22 for an exception related to ineffective internal control over compliance). Tests of controls should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 319.52 and 319.53). Tests of controls, which are directed toward either the effectiveness of the design or the operation of a control, may include such steps as (a) inquiries of appropriate personnel, including grant and contract managers; (b) the inspection of documents and reports; (c) the observation of the application of the specific controls; and (d) the reperformance of the application of the controls by the auditor. The auditor should perform such procedures (unless control is likely to be ineffective) regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

Evaluating the Results of Tests of Controls

8.24 If, when evaluating the results of tests of controls, the auditor is not able to support a low assessed level of control risk for major programs, the auditor is not required to expand his or her testing of internal control over compliance. The auditor may choose not to perform further tests. In this situation, the auditor would assess control risk at other than low, design tests

of compliance accordingly, and consider the need to report an audit finding (see paragraph 10.63). In general, a reportable condition or a material weakness will need to be reported. Similarly, the auditor may decide to expand the testing of internal control over compliance, but that decision would be based on whether the auditor considered expanded internal control testing to be more efficient than additional tests of compliance. The auditor should consider whether, based on the testing performed, control risk can be assessed at below the maximum to reduce substantive tests of compliance. If it cannot, the auditor should assess control risk at the maximum level.

Reportable Conditions and Material Weaknesses Related to Federal Programs

8.25 For purposes of reporting on internal control over compliance for federal programs, the definitions of a reportable condition and a material weakness, which are similar to those in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, are as follows:

- A *reportable condition* is a matter coming to the auditor's attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in the auditor's judgment, could adversely affect an entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.
- A *material weakness* in internal control over compliance is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

8.26 In performing a single audit, the auditor should be aware that reportable conditions and material weaknesses are to be considered as they relate to a type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. Furthermore, certain conditions may be reportable conditions for a major program and not be considered reportable conditions as they relate to the assertions of management in the financial statements.

Documentation Requirements

8.27 The auditor should document his or her understanding of the auditee's internal control components that was obtained to plan the audit, and should document the basis for his or her conclusions about the assessed level of control risk related to the internal control over compliance for major programs. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraphs 8.20 through 8.22, then the rationale for omitting such tests should be documented.

8.28 As noted in paragraphs 3.20 through 3.22, *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments.

* See footnote * to paragraph 3.20.

8.29 The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as the nature of the auditee's internal control over compliance. For example, the documentation of the understanding of internal control over compliance of a large, complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, the documentation may be less extensive. In general, the more complex the internal control over compliance and the more extensive the procedures performed, the more extensive the auditor's documentation.

Program Cluster Considerations

8.30 An entity may have separate controls related to individual federal programs that are treated as one program "cluster" under a Circular A-133 audit (for example, SFA and R&D—see paragraphs 1.18, 1.19, 2.18, 5.6, and 7.4 for a discussion of program clusters). In this case, when evaluating whether an identified deficiency is a reportable condition, the auditor should consider the significance of the deficiency in relation to the overall major program (program cluster). Following are some examples:

- Significant deficiencies in specific controls over the time cards of college work-study students would likely be considered a reportable condition when college work-study program expenditures are significant in relation to SFA programs.
- Significant deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would likely be a reportable condition when considered in relation to the total expenditures of R&D programs.
- A deficiency in an SFA or R&D program that was clearly insignificant to SFA or R&D, respectively, as a whole would not necessarily be considered a reportable condition.

Chapter 9

AUDIT CONSIDERATIONS OF FEDERAL PASS-THROUGH AWARDS

Introduction

9.1 Many nonfederal entities receiving federal awards make pass-through payments of federal awards to other entities that are considered subrecipients. The amount of those payments may be material to the pass-through entity's financial statements, individual major programs, or both. The auditor's consideration of pass-through federal awards in an audit of both pass-through entities and subrecipients of federal awards under Circular A-133 is discussed in this chapter. The auditee's and auditor's responsibilities with respect to activities carried out by vendors is also discussed in this chapter. An auditee with multiple federal funding agreements may be a pass-through entity in regard to some awards, a subrecipient in regard to other awards, and a vendor with respect to other agreements.

Definitions

9.2 Circular A-133 includes the following definitions that are relevant to pass-through awards:

- *Federal award*—federal financial assistance and federal cost-reimbursement contracts that nonfederal entities receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors.
- *Nonfederal entity*—a state, local government, or non-profit organization (NPO).
- *Recipient*—a nonfederal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program.
- *Pass-through entity*—a nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.
- *Subrecipient*—a nonfederal entity that expends federal awards received from a pass-through entity to carry out a federal program but does not include an individual who is a beneficiary of such a program. A subrecipient may also be a recipient of other federal awards directly from a federal awarding agency.
- *Vendor*—a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the federal program.

Applicability of Circular A-133

9.3 Circular A-133 applies to both recipients expending federal awards received directly from federal awarding agencies and subrecipients expending

federal awards received from a pass-through entity. Accordingly, both recipients and subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133 (see chapter 11 for a detailed discussion of program-specific audits).

9.4 The determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards passed through to subrecipients, the activity that requires the pass-through entity to comply with laws, regulations, and the provisions of contracts or grant agreements is the disbursement of funds to subrecipients. The activity that requires subrecipients to comply with laws, regulations, and the provisions of contracts or grant agreements is the expenditure of the pass-through award.

9.5 Payments received by a vendor for goods or services provided in connection with a federal program are not considered federal awards. Furthermore, Medicaid payments to a subrecipient for providing patient care services to Medicaid-eligible individuals are not considered federal awards expended under Circular A-133 unless a state requires the funds to be treated as federal awards expended because reimbursement is on a cost-reimbursement basis.

9.6 If a pass-through entity provides federal awards to subrecipients, the pass-through entity must monitor the subrecipients' activities to provide reasonable assurance that the subrecipients administer federal awards in compliance with federal requirements. As part of the compliance audit, the auditor of the pass-through entity must test and report on subrecipient monitoring (which is one of the fourteen types of compliance requirements in the *Compliance Supplement*—see paragraph 6.22) when federal awards passed through to subrecipients are material to a major program (see paragraphs 9.24 through 9.35). If the federal awards provided are immaterial or relate to a program that is not considered major, the auditor of the pass-through entity has no additional compliance auditing responsibilities related to the funds passed through to subrecipients.

9.7 Most of this chapter focuses on compliance auditing considerations for auditors of pass-through entities. However, paragraphs 9.43 through 9.47 provide additional considerations for auditors of subrecipients.

Pass-Through Entities, Subrecipients, and Vendors

Subrecipient Status Versus Vendor Status

9.8 The responsibilities for compliance with federal program requirements and the applicable compliance requirements to be tested by the auditor are significantly different for pass-through entities, subrecipients, and vendors. Guidance on distinguishing between a subrecipient and a vendor is provided in section 210 of Circular A-133 and is summarized in paragraphs 9.9 through 9.11.

Characteristics Indicative of a Federal Award Received by a Subrecipient

9.9 According to Circular A-133, characteristics indicative of a federal award received by a subrecipient are when the entity (see paragraph 9.12 for examples of the relationship between pass-through entities and subrecipients)—

- Determines who is eligible to receive what federal financial assistance.
- Has its performance measured against whether the objectives of the federal program are met.

- Has responsibility for programmatic decision making.
- Has responsibility for adherence to applicable federal program compliance requirements.
- Uses the federal funds to carry out a program of the entity as compared to providing goods or services for a program of the pass-through entity.

Characteristics Indicative of a Payment for Goods or Services Received by a Vendor

9.10 According to Circular A-133, the characteristics indicative of a payment for goods or services received by a vendor are when the entity (see paragraph 9.13 for examples of the relationship between recipients and vendors)—

- Provides the goods and services within normal business operations.
- Provides similar goods or services to many different purchasers.
- Operates in a competitive environment.
- Provides goods or services that are ancillary to the operation of the federal program.
- Is not subject to the compliance requirements of the federal program.

Use of Judgment in Determining Subrecipient or Vendor Status

9.11 Circular A-133 states that there may be unusual circumstances or exceptions to the listed characteristics in paragraphs 9.9 and 9.10. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present, and judgment should be used in determining whether an entity is a subrecipient or vendor. In some cases, it may be difficult to determine whether the relationship with the entity is that of a subrecipient or of a vendor. The federal cognizant agency for audit, the oversight agency for audit, or the federal awarding agency may be of assistance in making these determinations.

Description of Relationships

Pass-Through Entity and Subrecipient

9.12 Following are examples of a typical relationship between a pass-through entity and a subrecipient:

- A state department of education (pass-through entity) receives a federal award and is responsible for administering and disbursing the federal award to local school districts (subrecipients) according to a formula or some other basis.
- A regional planning commission (pass-through entity) receives a federal award for the feeding of elderly and low-income individuals, and the award is disbursed to NPOs (subrecipients) to support their feeding programs.
- A hospital (subrecipient) receives a federal award from a university (pass-through entity) to conduct research.
- A theater group (subrecipient) receives a federal award from a state arts commission (pass-through entity) to support a summer arts series.

Recipient and Vendor

9.13 Following are examples of a typical relationship between a recipient and a vendor:

- A local government (recipient) receives a federal award to provide mental health services in a designated area. Some of the funds are paid to a contractor (vendor) to repair a leaking roof.
- A county (recipient) receives a federal award to operate a Head Start program and pays a NPO (vendor) to provide temporary clerical services.
- An NPO (recipient) receives a federal award to run a preschool and pays a medical doctor (vendor) to perform health screening on a per-student basis.
- An NPO (recipient) receives a federal award to operate a child care center and pays a not-for-profit clinic (vendor) to perform physical exams.

Entity is Both a Subrecipient and a Pass-Through Entity

9.14 There are instances in which an entity can be both a subrecipient and a pass-through entity as shown in the following examples:

- A local government receives a pass-through federal award from a state government agency (the local government is a subrecipient) and further passes through a portion of the federal award to an NPO (the local government is also a pass-through entity) to administer a federal program.
- A not-for-profit area agency receives a pass-through federal award from a state (the not-for-profit area agency is a subrecipient) and further passes through a portion of the federal award to a for-profit health care provider (the not-for-profit area agency is also a pass-through entity). See paragraph 9.40 for a discussion of a pass-through entity's responsibilities when the subrecipient is a for-profit entity.

Vendor Compliance Considerations

Auditee's Responsibilities

9.15 Circular A-133 states that in most cases, the auditee's compliance responsibility for a vendor is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. A program's compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions that are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine compliance.

Auditor's Responsibilities

9.16 When vendors are responsible for program compliance, the auditor should determine whether vendor transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements if such transactions are material to a major program of the auditee. In such a case, the auditor would normally evaluate a vendor's compliance by reviewing the auditee's records and the results of the auditee's procedures for ensuring compliance by

the vendor. When the auditor cannot obtain sufficient assurance from reviewing the auditee's records and procedures, the auditor should consider the need to report a reportable condition. The auditor will also ordinarily need to perform additional procedures to determine compliance. These procedures may include testing the vendor's records or obtaining reports on compliance procedures performed by the vendor's independent auditor.

9.17 Prior to performing a single or program-specific audit, it is important for the auditor to understand the nature of the auditee's vendor relationships, whether the vendors are responsible for program compliance, the auditee's procedures for ensuring vendor compliance, and whether it will be necessary for the auditor to test vendor records. The auditor should consider including such information in the communication used to establish an understanding with the auditee (see paragraphs 3.6 and 3.7). If subsequent to undertaking a single or program-specific audit the auditor becomes aware of a significant vendor relationship that will require the auditor to perform additional procedures on vendor records, the auditor should inform the auditee that the requirements of Circular A-133 will not be met unless additional procedures are performed. If the auditee or vendor precludes the auditor from performing such additional procedures, the auditor should qualify his or her opinion or disclaim an opinion because of a scope limitation (see paragraphs 10.43 through 10.45 for a further discussion of scope limitations).

Single Audit Considerations of Pass-Through Entities

9.18 The following matters are relevant to planning and conducting a single audit of a pass-through entity:

- Pass-through entity responsibilities (see paragraph 9.19)
- Audit planning considerations (see paragraphs 9.20 through 9.22)
- Consideration of internal control over compliance (see paragraph 9.23)
- Subrecipient monitoring (see paragraphs 9.24 through 9.35)
- Reporting considerations (see paragraphs 9.36 through 9.39)
- For-profit subrecipients (see paragraph 9.40)
- Non-U.S.-based entities (see paragraph 9.41)
- A state's designation of a cluster of programs (see paragraph 9.42)

Pass-Through Entity Responsibilities

9.19 A pass-through entity is responsible for ensuring that subrecipients expend awards in accordance with applicable laws, regulations, and provisions of contracts or grants. Circular A-133 requires a pass-through entity to perform the following for the federal awards it provides to subrecipients:

- Identify the federal awards made by informing each subrecipient of the CFDA title and number, the award's name and number, the award year, whether the award is for R&D, and the name of the federal agency. When some of this information is not available, the pass-through entity should provide the best information available to describe the federal award.
- Advise subrecipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.

- Monitor the activities of subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- Ensure that subrecipients expending \$300,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of Circular A-133 for that fiscal year.
- Issue management decisions on audit findings within six months after receipt of subrecipients' audit reports, and ensure that subrecipients take appropriate and timely corrective action.
- Consider whether subrecipient audits necessitate the adjustment of the pass-through entity's own records.
- Require subrecipients to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with Circular A-133.
- Keep subrecipients' report submissions (or other written notification when the subrecipient is not required to submit a reporting package) on the file for three years from the date of receipt (see paragraphs 9.47, 10.76, and 10.78).

Audit Planning Considerations

Impact of Pass-Through Federal Awards on the Determination of Major Programs

9.20 As noted in paragraph 9.4, the determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards provided by a pass-through entity to subrecipients, the federal awards are deemed to be expended by the pass-through entity when the funds are disbursed to subrecipients, regardless of when subrecipients expend the federal funds. Accordingly, the amount of federal funds disbursed to subrecipients should be included in the total expenditures of federal awards of the pass-through entity and in the determination of the pass-through entity's major programs (see chapter 7 for a more detailed discussion of the determination of major programs).

Pass-Through Entity Request for a Program to Be Audited as a Major Program

9.21 When a subrecipient expends \$300,000 or more of federal awards, Circular A-133 permits the pass-through entity to request that the program be audited as a major program in lieu of the pass-through entity conducting or arranging for additional audits. If the pass-through entity makes such a request, it is required to pay the full incremental cost for such an audit (see paragraph 2.19 for additional information).

Materiality

9.22 The auditor of the pass-through entity should compare the amount of federal funds passed through to subrecipients with the total expenditures for each individual major program or cluster to determine if the amount is material. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely upon the auditor's work. When the amount of

federal funds passed through to subrecipients is material in relation to the major program being audited, the greater the need for the auditor to test the subrecipient-monitoring requirements. It should be noted that some federal programs are designed in such a manner that subrecipient expenditures are intended to be material to the pass-through entity's award. For example, the Community Services Block Grant requires a state to subgrant at least 90 percent of the state's award.

Consideration of Internal Control Over Compliance

9.23 As part of performing procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit of the pass-through entity to support a low assessed level of control risk for major programs, the auditor should consider the pass-through entity's internal control over compliance used to monitor subrecipients (see chapter 8 for an additional discussion of considerations concerning internal control over compliance). Tests of internal control over compliance used to monitor subrecipients may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified in paragraph 9.28. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the internal control over compliance, materiality, and professional judgment. Auditors should consider referring to part 6 of the *Compliance Supplement*, which describes (among other things) certain characteristics of internal control over compliance that, when present and operating effectively, may ensure compliance with program requirements for subrecipient monitoring. The results of the auditor's testing of internal control over compliance assist in determining the nature, timing, and extent of subrecipient monitoring compliance testing.

Subrecipient Monitoring

9.24 The Single Audit Act requires the pass-through entity to monitor subrecipients' use of federal awards through site visits, limited scope audits, or other means. Since the pass-through entity is held accountable for federal awards administered by their subrecipients, the pass-through entity needs to establish an appropriate subrecipient-monitoring process and to decide what, if any, additional monitoring procedures may be necessary to ensure the subrecipients' compliance. Arrangements for subrecipient monitoring should be made by the pass-through entity in its agreements with subrecipients.

9.25 Auditors must consider subrecipient monitoring in a compliance audit of an entity that disburses to subrecipients federal awards that are material to a major program (see the discussion of materiality in paragraph 9.22). The auditor should consider whether the pass-through entity monitors subrecipients and has established internal control over compliance that provides reasonable assurance that subrecipients are managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of the pass-through entity's major programs.

Compliance Supplement Guidance

9.26 One of the fourteen types of compliance requirements included in the *Compliance Supplement* is subrecipient monitoring. The *Compliance Supplement*

identifies several audit objectives for subrecipient monitoring. According to the *Compliance Supplement*, in a single audit of a pass-through entity, the auditor should obtain an understanding of internal control, assess risk, and test internal control as required by the Circular, and determine whether the pass-through entity—

- Identified federal award information and compliance requirements to the subrecipient, and approved only allowable activities in the award documents.
- Monitored subrecipient activities to provide reasonable assurance that the subrecipient administers federal awards in compliance with federal requirements.
- Ensured that the required audits were performed, and required appropriate corrective action concerning monitoring and audit findings.
- Evaluated the impact of subrecipient activities on the pass-through entity.

9.27 The *Compliance Supplement* also identifies the suggested audit procedures for testing the compliance audit objectives for pass-through entities (see paragraph 6.44 for a further discussion of suggested audit procedures). The auditor may consider coordinating the subrecipient-related tests performed as part of activities allowed or unallowed (tests that subrecipient agreements were for allowable activities), cash management (tests of cash reports submitted by subrecipients), eligibility (tests that subawards were made only to eligible subrecipients), and procurement (tests of suspension and debarment certifications) with the tests of subrecipient monitoring.

Pass-Through Entity Monitoring Procedures

9.28 The monitoring procedures used by the pass-through entity may include on-site visits, reviews of documentation supporting requests for reimbursement, and limited-scope audits. Limited-scope audits are agreed-upon procedures engagements that are conducted in accordance with the AICPA attestation standards, and that are paid for and arranged by a pass-through entity and only address one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and reporting. Following are other monitoring procedures that a pass-through entity may perform:

- Reviewing grant applications submitted by subrecipients to determine that—
 - Applications are filed and approved in a timely manner
 - Each application contains the condition that the subrecipient comply with the federal requirements set by the federal agency
- Establishing internal control over compliance to provide reasonable assurance that—
 - Funds are disbursed to subrecipients only on an as-needed basis
 - Funds are disbursed to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis
 - Refunds that are due from subrecipients are billed and collected in a timely manner
 - Subrecipients and other entities and individuals receiving federal funds meet eligibility requirements
- Reviewing financial and technical reports received from subrecipients on a timely basis and investigating unusual items

- Reviewing subrecipient audit reports, to evaluate them for completeness and for compliance with applicable laws and regulations
- Evaluating audit findings; issuing appropriate management decisions, if necessary; and determining if an acceptable plan for corrective action has been prepared and implemented
- Reviewing previously detected deficiencies and determining that corrective action was taken

Monitoring When the Subrecipient Has a Single or Program-Specific Audit

9.29 As noted in paragraph 9.3, subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133. If subrecipients have a single or program-specific audit, the pass-through entity's receipt and review of the results of that audit and its action on related findings may be sufficient to meet the subrecipient-monitoring requirements of Circular A-133. However, it is more likely that the receipt and review of such audit results should be merely one tool that should be used by the pass-through entity as part of a comprehensive subrecipient-monitoring process. Pass-through entities should be aware that a single audit is likely to provide varying degrees of assurance concerning a particular program. For example, a pass-through award may not have been tested as a major program as part of a subrecipient's audit. For this reason, the pass-through entity should consider the testing and results of the single audit of the subrecipient to determine what effect those results should have on other monitoring procedures employed by the pass-through entity.

9.30 In many cases, the pass-through entity will not have received all the subrecipient audit reports covering the time period being audited at the pass-through entity in time to incorporate the results into its own audit. The reports for the pass-through entity and the subrecipient are not required to be issued simultaneously, but the pass-through entity is required to have internal control over compliance in place, to determine that subrecipient audit reports have been received and that corrective action is taken after the receipt of the subrecipient's audit. If the subrecipient's audit report is current, it need not cover the same period as the pass-through entity's audit. If the pass-through entity has an effective system for monitoring subrecipients, its auditor should be able to rely on the subrecipient's audit cycle, even if it is not coterminous with the pass-through recipient's fiscal year.

Considering Risk Factors When Developing Monitoring Procedures

9.31 The preamble to Circular A-133 states that the OMB expects pass-through entities to consider various risk factors (such as the relative size and complexity of the federal awards administered by subrecipients, the entity's prior experience with each subrecipient, and the cost-effectiveness of various monitoring procedures) in developing subrecipient-monitoring procedures. For example, if a pass-through entity provides a large percentage of the only federal award it expends to ten subrecipients that each expend less than \$300,000 in federal awards annually, the pass-through entity should carefully consider the most cost-effective method of monitoring these federal awards. Perhaps the majority of this federal award is provided to two subrecipients. The pass-through entity might consider conducting site visits at these two subrecipients and simply reviewing the documentation supporting requests for reimbursement from the other eight subrecipients. Conversely, if a small

percentage of a federal award is provided to subrecipients that each expend less than \$300,000 in federal awards, the risk to the pass-through entity is most likely low and, therefore, the monitoring procedures could be minimal.

Unallowable Audit Costs

9.32 For subrecipients that expend less than \$300,000 in federal awards annually, the cost of any audits or attestation engagements (other than the limited-scope audits paid for and arranged by a pass-through entity as described in paragraph 9.28), are not allowable costs and, therefore, cannot be charged to any federal award. Accordingly, Circular A-133 would prohibit the cost of a financial statement audit conducted in accordance with GAAS or *Government Auditing Standards* from being charged (by either a pass-through entity or subrecipient) to federal awards for a subrecipient that expends less than \$300,000 in federal awards annually. The allowability of audit costs is discussed in greater detail in paragraph 2.12.

When the Subrecipient Monitoring System Is Not Sufficient

9.33 The auditor may determine that the pass-through entity's subrecipient-monitoring system is not sufficient to ensure subrecipient's compliance with laws, regulations, and the provisions of grants and contracts. In this situation, the auditor should report a reportable condition (and possibly a material weakness) and consider whether the insufficient monitoring system represents an instance of noncompliance that should be reported as a compliance finding. The effect of the noncompliance on the opinion on compliance for major programs is primarily a function of the pervasiveness of the lack of monitoring and the materiality of subrecipient funding to a program. For example, if the pass-through entity did not perform subrecipient-monitoring procedures and 90 percent of the program was passed through to subrecipients, an opinion modification would likely be warranted. This would likely be the case even if the scope of the audit was expanded to include additional audit procedures to determine that the subrecipients actually complied with laws and regulations.

9.34 There may be instances in which the pass-through entity asks the auditor to perform additional procedures to determine the compliance of a subrecipient (such as conducting tests of records at the subrecipient's site). This would be considered an expansion of the scope of the audit. The auditor should be aware that such an expansion of the scope of the audit would not be sufficient to remedy the reportable condition (or material weakness) and, if applicable, noncompliance of the pass-through entity's monitoring system. However, an expansion of the scope of the audit may remedy the noncompliance related to the type of compliance requirement being tested (for example, eligibility).

9.35 The auditor should also consider any implications of an insufficient subrecipient-monitoring system on the opinion on the financial statements. If amounts passed through to subrecipients are considered material to the financial statements of the pass-through entity, the auditor should determine whether the report on the financial statements should be modified. Before making this determination, the auditor should take into consideration any evidential matter that may be available to the auditor (such as subrecipients' Circular A-133 audit reports and other financial reports that may have been submitted to the pass-through entity) that could indicate that the subrecipients administered the program in compliance with laws and regulations.

Further, the auditor should also consider whether it is necessary to report an internal control or compliance finding in the report issued to meet the requirements of *Government Auditing Standards*.

Reporting Considerations

Schedule of Expenditures of Federal Awards

9.36 Circular A-133 states that, to the extent practical, pass-through entities should identify in the schedule of expenditures of federal awards the total amount provided to subrecipients from each federal program (see chapter 5 for an additional discussion of the schedule). If a pass-through entity is unable to identify amounts provided to subrecipients, the auditor should consider whether a reportable condition (and possibly a material weakness) should be reported. The auditor should also consider whether material non-compliance (for subrecipient monitoring) that is required to be reported as an audit finding has occurred.

Evaluation of Audit Findings

9.37 Circular A-133 requires the auditor to consider a finding in relation to the type of compliance requirement (subrecipient monitoring, in this case) or an audit objective identified in the *Compliance Supplement*, whether or not the finding can be quantified. For example, the auditor may discover that a pass-through entity consistently failed to provide its subrecipients with federal award information, including applicable compliance requirements. The pertinent audit objective included in the *Compliance Supplement* and relating to this example is for the auditor to “determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient.” Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance is material in relation to the audit objective and, therefore, must be reported as an audit finding. In addition, the auditor must consider whether reportable conditions (and possibly, material weaknesses in internal control) exist and require reporting with respect to subrecipient monitoring.

Effect of Subrecipients’ Noncompliance on the Pass-Through Entity’s Report

9.38 The instances of noncompliance reported in subrecipients’ audit reports are not required to be included in the pass-through entity’s audit report. However, the auditor of the pass-through entity should consider the effects of reported instances of subrecipient noncompliance or indications of weaknesses in the pass-through entity’s subrecipient-monitoring system that could have a material effect on each of the pass-through entity’s major programs.

Adjustment of Pass-Through Entity Financial Records and Reports

9.39 Questioned costs at the subrecipient level that are found to be unallowable by the pass-through entity may require the pass-through entity to adjust its financial records and its federal expenditure reports. The total of allowable program costs in excess of required expenditure levels and the requirements of individual programs regarding the timing of claims will affect whether the pass-through entity will need to reflect a liability to the awarding agency in its financial statements. As part of the finding-resolution process, the

pass-through entity should estimate the total unallowable costs that are associated with each subrecipient finding and consider the need to adjust financial records and federal expenditure reports. The failure of the pass-through entity to adjust its records and federal reports should be considered by the auditor in forming an opinion on compliance for major programs.

For-Profit Subrecipients

9.40 Since Circular A-133 does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. Circular A-133 states that the contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits. The auditor's responsibilities related to for-profit subrecipients are similar to those of not-for-profit subrecipients, see paragraphs 9.24 through 9.35 (as applicable) for a further discussion of subrecipient monitoring.

Non-U.S.-Based Entities

9.41 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient (see paragraph 2.6 for a further discussion of non-U.S.-based entities). Therefore, the responsibilities that a pass-through entity and its auditor have for a non-U.S.-based entity are the same as those for a for-profit subrecipient (see paragraph 9.40).

State Designation of a Cluster of Programs

9.42 Circular A-133 includes a provision that allows a state to designate as a cluster a grouping of closely related programs that share common compliance requirements. When designating a cluster of programs, a state is required by Circular A-133 to identify the federal awards included in the cluster and to advise subrecipients of the compliance requirements applicable to the cluster. See paragraphs 1.18, 1.19, 2.18, 5.6, 7.4, and 8.30 for additional discussion of clusters.

Circular A-133 Audit Considerations of Subrecipients

9.43 Auditors of subrecipients should be aware that subrecipients have additional considerations under Circular A-133. These considerations are related to additional compliance requirements established by the pass-through entity, information included in the schedule of expenditures of federal awards, audit findings, and the submission of the report.

Additional Compliance Requirements Established by Pass-Through Entities

9.44 Federal awards are normally distributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency

and, in some instances, additional requirements established by the pass-through entity. Hence, in addition to providing an audit satisfying the requirements of Circular A-133, the auditor may be engaged to test compliance with requirements specified by the pass-through entity.

Information Included in the Schedule of Expenditures of Federal Awards

9.45 For federal awards received as a subrecipient, the schedule of expenditures of federal awards is required to include the name of the pass-through entity and identifying number assigned by the pass-through entity. Circular A-133 states that to make the schedule easier to use, subrecipients may choose to provide information requested by federal awarding agencies and pass-through entities, although this information is not required. Chapter 5 includes more detailed information about the schedule.

Audit Findings

9.46 Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Circular A-133 states that where practical, audit findings should be organized by federal agency or pass-through entity (see chapter 10 for an additional discussion of audit findings).

Submission of Report

9.47 Section 320(e) of Circular A-133 has additional report-submission responsibilities for subrecipients. When a subrecipient is not required to submit a reporting package to the pass-through entity (because it has no audit findings or the summary schedule of prior audit findings does not report the status of any audit findings), the subrecipient is required to provide written notification of this to the pass-through entity. The required contents of the written notification and the submission of the report by subrecipients are discussed in paragraph 10.76.

Chapter 10

AUDITOR REPORTING REQUIREMENTS AND OTHER COMMUNICATION CONSIDERATIONS IN A SINGLE AUDIT

Overview

10.1 In this chapter the auditor's reporting requirements and other communication considerations in a single audit under Circular A-133 are discussed. The auditor's reporting requirements in a program-specific audit are discussed in chapter 11.

10.2 The auditor's reporting responsibilities in a single audit are driven by the three levels of auditing standards and requirements: GAAS, *Government Auditing Standards*, and Circular A-133. These standards and requirements expand the level of auditor responsibility from reporting on an auditee's financial statements to also reporting on internal control and on compliance. The auditor has additional reporting responsibilities for the audit of the financial statements in accordance with *Government Auditing Standards* (see chapter 4), and for the compliance audit applicable to major programs in accordance with Circular A-133 (see chapters 6 through 8). The auditor also has additional communication considerations under GAAS and *Government Auditing Standards* related to matters noted in the single audit.

Circular A-133 Requirements

Auditor's Reports

10.3 Circular A-133 requires the auditor's report(s) to include—

- An opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) (see paragraph 10.12 for a discussion of the basis of accounting) and an opinion (or a disclaimer of opinion) on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- A report on the internal control related to the financial statements and on the internal control related to major programs. This report must describe the scope of testing of internal control and the results of the tests and, where applicable, must refer to the separate schedule of findings and questioned costs.
- A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report must also include an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program, and where applicable, must refer to the separate schedule of findings and questioned costs.

- A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67).

The auditor's reports recommended in this SOP are described in paragraphs 10.8 through 10.10 below.

Data Collection Form

10.4 Circular A-133 also requires the auditor to complete applicable sections and sign a data collection form that summarizes the auditor's results, findings, and questioned costs (see paragraphs 10.71 through 10.73).

Other Communication Considerations

10.5 The auditor has certain additional communication considerations under GAAS and *Government Auditing Standards* related to internal control, noncompliance, fraud, illegal acts, and other matters noted in the single audit (see paragraphs 10.13 through 10.30).

Reporting Package

10.6 The auditee is required to submit a reporting package that includes the following:

- Financial statements and a supplementary schedule of expenditures of federal awards (see chapters 4 and 5);
- Auditor's reports (see paragraphs 10.8 through 10.10);
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70);
- A corrective action plan (see paragraphs 10.68 through 10.70).

10.7 Although not part of the reporting package, the report submission to the Federal Audit Clearinghouse (FAC) must also include the data collection form described in paragraphs 10.71 through 10.73. The requirements for report submission are discussed in paragraphs 10.74 through 10.79.

Recommended Auditor's Reports

10.8 Reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued:

- a. An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards (see paragraph 10.35 through 10.37)¹
- b. A report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* (see paragraphs 10.38 through 10.40)

¹ Note that in certain circumstances the auditor may report on the schedule of expenditures of federal awards in his or her report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133. See paragraph 10.36 for a further discussion.

- c. A report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133 (see paragraphs 10.46 through 10.54)
- d. A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67)

10.9 Example reports are provided in appendix D of this SOP. As noted previously, those reports combine reports on compliance and internal control at the financial statement audit level and at the major program compliance audit level. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. The basic elements of each of the recommended reports are discussed later in this chapter. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

10.10 Table 10.1 provides a matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133.

Table 10.1

Recommended Reporting in Single Audits

Report	Required by—		
	GAAS	Government Auditing Standards	Circular A-133
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or a disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Reporting on the Financial Statements and Supplementary Schedule of Expenditures of Federal Awards in Accordance With GAAS and *Government Auditing Standards*

10.11 In this section the reporting and additional communication requirements under GAAS and *Government Auditing Standards* that are related to a financial statement audit and the supplementary schedule of expenditures of federal awards are discussed.

Basis of Accounting

10.12 Circular A-133 and *Government Auditing Standards* do not prescribe the basis of accounting that must be used by auditees to prepare their financial statements and the schedule of expenditures of federal awards. However, auditees are required to disclose the basis of accounting and the significant accounting policies used in preparing the financial statements and the schedule of expenditures of federal awards. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts included in the schedule of expenditures of federal awards. The auditor is required to report whether the financial statements are presented fairly in all material respects in conformity with GAAP and whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole (see paragraphs 4.3 and 10.13 for a discussion of the auditor's responsibilities when the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP).

GAAS Requirements

10.13 The applicable reporting requirements are established in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). For an auditee that prepares its financial statements in conformity with a basis of accounting other than GAAP, auditors should follow the guidance in SAS No. 62, *Special Reports*. In reporting on the supplementary schedule of expenditures of federal awards, auditors should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Auditors may also refer to the AICPA Audit and Accounting Guides *Not-For-Profit Organizations*, *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and *Health Care Organizations*,^[2] for additional guidance on reporting on the financial statements of specific industries. See also paragraphs 10.17 through 10.30 for a discussion of additional reporting and communication requirements.

10.14 SAS No. 61, *Communication With Audit Committees*, as amended by SAS No. 89, *Audit Adjustments*, requires the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for the oversight of the financial reporting process. Matters to be communicated include (among other things) the auditor's responsibilities, significant accounting policies, management judgments and accounting estimates, significant audit adjustments, disagreements with management, and difficulties encountered in performing the audit. In addition to the SAS No. 61 requirements described above, *Government Auditing Standards* also requires the auditor to communicate certain information during the planning stages of the audit. See paragraphs 3.14 and 3.15 for a further discussion.

Government Auditing Standards Requirements

10.15 Government Auditing Standards requires that in addition to reporting on the financial statements, the auditor report on (1) compliance with laws, regulations, and provisions of contracts and grant agreements that could

^[2] [Deleted.]

have a direct and material effect on the financial statements amounts and (2) the scope of testing of the auditee's internal control over financial reporting and on the results of the tests.

10.16 The reporting standards for financial audits in *Government Auditing Standards* contain four additional reporting standards for financial statement audits beyond GAAS:

- a. When the report on the financial statement is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, audit reports should state that the audit was made in accordance with generally accepted government auditing standards. This SOP recommends the following language be included in the auditor's report to meet this requirement: "we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."³ *Government Auditing Standards* also acknowledges that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. For example, the auditee may need a financial statement audit to issue bonds. In this case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS (see paragraphs 5.11 through 5.14 of *Government Auditing Standards*).
- b. The report on the audit of the financial statements should either (1) describe the scope of the auditor's testing of compliance with laws and regulations and internal control over financial reporting and present the results of those tests or (2) refer to the separate report(s) containing that information (see paragraphs 5.15 through 5.28 of *Government Auditing Standards*). When auditors report separately on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that they have issued the additional report. It should also state that the report on compliance with laws and regulations and internal control over financial reporting is an integral part of an audit performed in accordance with *Government Auditing Standards*, and in considering the results of the audit, that the report(s) should be read in conjunction with the auditor's report on the financial statements. The financial statement reporting recommended in this SOP (appendix D, examples 1 and 1a), illustrates the second option to refer to a separate report on compliance with certain provisions of laws, regulations, contracts, and grants and on internal control over financial reporting. In presenting the results of tests, the auditor should report fraud, illegal acts, other material noncompliance, and reportable conditions in internal control over financial reporting (see paragraphs 10.17 through 10.30). In some circumstances, the auditor should report fraud and illegal acts directly to parties external to the audited entity (see paragraphs 10.23 through 10.25).

³ The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

- c. If certain information is prohibited from general disclosure (that is, prohibited from general disclosure by federal, state, or local laws or regulations), the audit report should state the nature of the information omitted and the requirement that makes the omission necessary (see paragraphs 5.29 through 5.31 of *Government Auditing Standards*).
- d. Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audit (including external funding organizations), unless legal restrictions prevent it.⁴ Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection (see paragraphs 5.32 through 5.35 of *Government Auditing Standards*).

Fraud, Illegal Acts, and Other Noncompliance

GAAS Requirements

10.17 In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.17), the auditor's responsibilities with respect to the consideration of illegal acts,⁵ including communications with the audit committee or others with equivalent authority or responsibility are discussed.⁶ Paragraph 17 of SAS No. 54, requires the auditor to assure himself or herself that the audit committee or others with equivalent authority and responsibility are adequately informed with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements. If senior management is involved, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it. Paragraphs 4.24 through 4.31 summarize the other requirements of SAS No. 54. The auditor should also consider the effect of any noncompliance on the financial statements, and should modify the auditor's report on those financial statements as necessary in accordance with SAS No. 58.

10.18 The auditor's responsibilities for communications about fraud to management, the audit committee, and others based on a financial statement audit in accordance with GAAS are discussed in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor

⁴ Note that when public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately.

⁵ SAS No. 54 defines the term *illegal acts* as violations of laws or government regulations.

⁶ For auditees that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

defalcation by an employee at a low level in the auditee's organization. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. The disclosure of possible fraud to parties other than the auditee's senior management and its audit committee is ordinarily not part of the auditor's responsibility and would ordinarily be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the auditee may exist:

- To comply with certain legal and regulatory requirements
- To a successor auditor when the successor makes inquiries in accordance with SAS No. 84, *Communications Between Predecessor and Successor Auditors*
- In response to a subpoena
- To a funding agency or other specified agency in accordance with the requirements for audits of entities that receive governmental financial assistance (see paragraphs 10.23 through 10.25)

10.19 When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions that relate to the auditee's internal control and that should be communicated to senior management and the audit committee (see paragraphs 10.26 through 10.30). The auditor may also wish to communicate other risk factors that are identified, when the auditee can reasonably take actions to address the risk.

10.20 In paragraphs 38 through 40 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.38–.40), the communication requirements of SAS No. 82 are further discussed. In paragraphs 4.32 through 4.37 of this SOP, the other requirements of SAS No. 82 are summarized. See paragraphs 6.7 through 6.12 for a discussion of the auditor's consideration of fraud risk in an audit of an auditee's compliance with specified requirements applicable to its major programs.

Government Auditing Standards Requirements

10.21 With regard to fraud and illegal acts, *Government Auditing Standards* requires auditors to report relevant information (in writing) when the auditor concludes, based on evidence obtained, that fraud or an illegal act has occurred or is likely to have occurred.^[7] Auditors do not need to report information about fraud or illegal acts that is clearly inconsequential. Therefore, auditors are required to present in the report the same fraud and illegal acts that they report to audit committees under GAAS (see paragraphs 10.17 through 10.20). *Government Auditing Standards* also requires auditors to report other noncompliance (for example, a violation of a contract provision) that is material to the financial statements. In presenting fraud, illegal acts, or other noncompliance that are required to be reported, auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* for objectives, scope, and methodology; audit results; the views of responsible officials; and report presentation standards (as appropriate).

^[7] [Deleted.]

10.22 When auditors detect fraud, illegal acts, or other noncompliance that do not meet the criteria in paragraph 5.18 of *Government Auditing Standards* for reporting (summarized in paragraph 10.21), paragraph 5.20 of *Government Auditing Standards* requires auditors to communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they are reporting on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, or other noncompliance.

Direct Reporting of Fraud and Illegal Acts

10.23 Paragraphs 5.21 through 5.25 of *Government Auditing Standards* provide guidance on the direct reporting of fraud and illegal acts. *Government Auditing Standards* requires that in addition to any legal requirements for the direct reporting of fraud or illegal acts, auditors must report fraud or illegal acts directly to parties outside the auditee in the following two circumstances (auditors should meet these requirements even if they have resigned or been dismissed from the audit):

- a. The auditee may be required by law or regulation to report certain fraud or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such fraud or illegal acts to the auditee, and it fails to report them, then auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.
- b. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statement or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

10.24 In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, the auditors should report the fraud or illegal acts directly, as discussed previously.

10.25 Paragraph 4.16 of *Government Auditing Standards* reminds auditors that under some circumstances, laws, regulations, or policies may require them to report indications of certain types of fraud or illegal acts promptly to law enforcement or investigatory authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities, legal counsel, or both, if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

Internal Control Over Financial Reporting

10.26 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance in identifying and reporting conditions that relate to an auditee's internal control observed during an audit of financial statements. In addition to providing guidance on communicating reportable conditions and identifying material weaknesses in the internal control over financial reporting, SAS No. 60 states that because timely communication may be important, the auditor may choose to communicate significant matters related to the internal control over financial reporting during the course of the audit rather than after the audit is concluded.

10.27 Written reporting on internal control matters under *Government Auditing Standards* is based on the auditor's consideration of the internal control over financial reporting as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). The report does not express an opinion on the auditee's internal control over financial reporting, but rather describes the extent of the work performed, as required by SAS No. 55. The report includes the requirements of SAS No. 60, as well as the additional requirements of *Government Auditing Standards*.

10.28 With regard to matters noted in an audit that relate to the internal control over financial reporting, paragraph 5.26 of *Government Auditing Standards* requires auditors to report deficiencies in internal control that they consider to be reportable conditions as defined by SAS No. 60. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. The illustrative report in example 2 of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when no reportable conditions are noted during an audit. In reporting reportable conditions, auditors are required to identify those that are individually or cumulatively material weaknesses. Auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* when reporting reportable conditions or material weaknesses. The illustrative report in example 2a of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when reportable conditions (whether or not they are considered to be material weaknesses) are noted during an audit.

10.29 Paragraph 5.28 of *Government Auditing Standards* states that when auditors detect deficiencies in the internal control that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated those deficiencies in internal control in a management letter to top management, they should refer to that management letter when they report on internal control (examples 2 and 2a of appendix D illustrate such a reference to the management letter). All communications to the auditee about deficiencies in the internal control should be documented in the working papers.

10.30 The following table summarizes the differences between SAS No. 60 and *Government Auditing Standards* with respect to reporting internal control matters.

	Government Auditing Standards	SAS No. 60
When is reporting required?	In every financial statement audit	When reportable conditions are noted
What is the form of the report?	Written	Oral or written, preferably in writing
Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses?	Yes	Permitted but not required

Reporting When Portions of a Governmental Reporting Entity Do Not Have an Audit in Accordance With Government Auditing Standards

10.31 Since the implementation of Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, it is becoming more frequent for governments that are required to have an audit in accordance with *Government Auditing Standards* to include as part of the reporting entity component units that are not required to have such an audit. When this occurs, the auditor should consider modifying his or her report on the financial statements and also the report issued to meet the requirements of *Government Auditing Standards*.

10.32 With regard to the report on the financial statements of the reporting entity, if a material component unit or fund is not required to have an audit in accordance with *Government Auditing Standards* and the report on the financial statements is required to state that the audit was performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*. An audit includes examining . . .

10.33 With regard to the report issued on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of example 2 or 2a of appendix D to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

We have audited the financial statements of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by

the Comptroller General of the United States. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*.

Implementing Regulations of Certain Federal Awarding Agencies May Define Entity to Be Audited Differently Than GAAP

10.34 The regulations implementing Circular A-133 may define the entity to be audited for single audit purposes differently than the reporting entity would be defined in accordance with GAAP. For example, SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, requires presentation of consolidated financial statements when one NPO (the parent) controls the voting majority of the Board of and has an economic interest in another NPO. If the regulations of the federal agency that provides federal awards to the parent define the entity for single audit purposes to consist of only the parent, audited parent-only financial statements instead of consolidated financial statements must be submitted to comply with these regulations. If consolidated financial statements are not also prepared as required by GAAP, the auditor should consider whether other than an unqualified opinion due to a material departure from GAAP should be expressed on the parent-only financial statements. See paragraphs 35 through 60 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.35–.60) for guidance on reporting when there is a departure from GAAP.

Opinion on the Financial Statements and on the Supplementary Schedule of Expenditures of Federal Awards

Report Requirements*

10.35 The auditor's standard report on the financial statements and on the supplementary schedule of expenditures of federal awards identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion on the financial statements and supplementary schedule of expenditures of federal awards in separate opinion paragraphs. The basic elements of the report are—

- a. A title that includes the word *independent*.
- b. A statement that the financial statements identified in the report were audited.
- c. A statement that the financial statements are the responsibility of the auditee's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.

* The Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition) (Guide) contains guidance for planning, performing, evaluating the results of, and reporting on the audits of financial statements issued by state and local governments that have or are required to apply the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. The Guide is effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply the provisions of GASB Statement Nos. 34 or 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. Earlier application of the Guide is encouraged if a government issues financial statements that apply GASB Statement Nos. 34 or 35 after the Guide is issued. The Guide specifies that auditor reporting on the audits of such governmental financial statements should be based on *opinion units*. Thus, several of the basic elements listed in this paragraph will change. Auditors who are auditing the financial statements of state and local governments using the provisions of the Guide should refer to Example 14A.1 in the Guide for an illustration of unqualified opinions on a government's basic financial statements.

- d. A statement that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards) and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.⁸
- e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- f. A statement that an audit includes—
 - Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
 - Assessing the accounting principles used and significant estimates made by management.
 - Evaluating the overall financial statement presentation.
- g. A statement that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- h. For a government, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the balance sheet date, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the period then ended in conformity with GAAP; for a not-for-profit organization, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the date of the statement of financial position, and the changes in its net assets and its cash flows for the period then ended in conformity with GAAP.⁹ The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).
- i. A reference to the separate report on compliance with certain provisions of laws, regulations, contracts, and grant agreements and on the internal control over financial reporting prepared in accordance with *Government Auditing Standards*.¹⁰ If this reporting is included in the report on the financial statements, this reference is not required (this SOP recommends separate reporting). See paragraph 10.16.
- j. A description of the accompanying supplementary information (for example, the schedule of expenditures of federal awards, combining and individual fund and account group financial statements and schedules, etc.). This identification may be by descriptive title or by page number of the document.
- k. A statement that the accompanying supplementary information, including the schedule of expenditures of federal awards required by

⁸ See footnote 3.

⁹ If an auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP, the auditor is still required to express or disclaim an opinion and should follow the reporting in SAS No. 62, *Special Reports*.

¹⁰ See paragraphs 10.15, 10.16, and 10.21 through 10.30 for a discussion of reporting on compliance and on the internal control based on a financial statement audit in accordance with *Government Auditing Standards*.

Circular A-133, is presented for purposes of additional analysis and is not a required part of the financial statements.¹¹ See paragraph 10.36.

- l. An opinion on whether the accompanying supplementary information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.
- m. The manual or printed signature of the auditor's firm.
- n. The date of the audit report.

Reporting on the Schedule of Expenditures of Federal Awards

10.36 This SOP recommends that the auditor report on the schedule of expenditures of federal awards in the report on the financial statements. However, some entities do not present the schedule with the financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate how to incorporate the reporting on the schedule into the Circular A-133 report. See also paragraphs 10.50 through 10.52 for information on dating the reports in this situation and paragraph 10.13 for a further discussion of reporting on the schedule.

10.37 Examples of the auditor's opinion on the financial statements and on the supplementary schedule of expenditures of federal awards are presented in examples 1 and 1a of appendix D.

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards

10.38 This SOP recommends that the reporting on the scope of the auditor's testing of compliance and on the internal control over financial reporting based on an audit of the financial statements as required by *Government Auditing Standards* be combined in one report (see paragraphs 10.8 through 10.10).

10.39 The basic elements of the auditor's standard report on compliance and on the internal control over financial reporting (see paragraph 4.12) based on an audit of the financial statements in accordance with *Government Auditing Standards* are—

- a. A statement that the auditor has audited the financial statements of the auditee and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards) and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.¹²

¹¹ If the report on the financial statements is issued for an audit that is not subject to Circular A-133 (that is, an audit in accordance with GAAS and *Government Auditing Standards* only), this reference to the schedule of expenditures of federal awards and Circular A-133 should be deleted.

¹² See footnote 3.

- c. A statement that as part of obtaining reasonable assurance about whether the auditee's financial statements are free of material misstatement, the auditor performed tests of the auditee's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.
- d. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.
- e. A statement that notes whether the results of tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*¹³ and, if they are, describes the instances of noncompliance or refers to the schedule of findings and questioned costs in which they are described.¹⁴
- f. If applicable, a statement that certain immaterial instances of noncompliance were communicated to management in a separate letter.¹⁵
- g. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.
- h. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- i. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- j. If applicable, a description of the reportable conditions noted or a reference to the schedule of findings and questioned costs in which the reportable conditions are described.¹⁶
- k. The definition of a material weakness.
- l. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, describes the material weaknesses noted or refers to the schedule of

¹³ See paragraph 10.21 for a discussion of noncompliance matters that need to be reported under *Government Auditing Standards*.

¹⁴ For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), any reportable instances of noncompliance, reportable conditions, and material weaknesses can either be described in the body of the report or the report can refer to a separate schedule that summarizes the findings noted. This statement should be modified accordingly. For an audit in accordance with Circular A-133, all findings, including those required to be reported under *Government Auditing Standards*, must be included in the schedule of findings and questioned costs.

¹⁵ See paragraph 10.22 for a discussion of reporting other noncompliance matters to top management in accordance with *Government Auditing Standards*.

¹⁶ See footnote 14.

findings and questioned costs in which they are described.¹⁷ If there are no reportable conditions noted, a statement is made that no material weaknesses were noted.

- m. If applicable, a statement that other matters involving the internal control over financial reporting were communicated to management in a separate letter.¹⁸
- n. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.^{19, 20}
- o. The manual or printed signature of the auditor's firm.
- p. The date of the auditor's report.

10.40 Examples of the auditor's report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* are included in examples 2 and 2a of appendix D.

Reporting on a Compliance Audit of Major Federal Programs

10.41 In this section the auditor's reports that are issued based on a compliance audit of major programs in accordance with Circular A-133 are discussed. The report on compliance with requirements applicable to major programs expresses the auditor's opinion on whether the auditee complied with the requirements that, if noncompliance occurred, could have a direct and material effect on a major program. Although the guidance in SAS No. 58 addresses reporting on audited financial statements, auditors may find its guidance useful when reporting on a compliance audit of major programs.

Material Instances of Noncompliance

10.42 When the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with those requirements, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report (see examples 3a and 5 of appendix D). The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. See paragraphs 6.13 through 6.16 for a further discussion of material instances of noncompliance.

Scope Limitations

10.43 Testing an auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements (referred to as "compliance requirements")

¹⁷ See footnote 14.

¹⁸ See paragraph 10.29 for a discussion of other internal control matters to be communicated to top management in accordance with *Government Auditing Standards*.

¹⁹ For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), the reference to federal awarding agencies and pass-through entities should be deleted.

²⁰ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

requires the auditor to make a comply/noncomply decision about an auditee's adherence to those compliance requirements. The auditor is able to express an unqualified opinion only if he or she has been able to apply all the procedures the auditor considers necessary in the circumstances. Restrictions on the scope of the audit—whether imposed by the client or by circumstances such as the timing of the auditor's work, an inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records—may require auditors to qualify their opinion or to disclaim an opinion. In these instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor's report. Furthermore, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements. See example 4 of appendix D for an illustration of a qualified opinion on compliance due to a scope limitation.

10.44 The auditor's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance.

10.45 When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph all of the substantive reasons for the disclaimer. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should disclose any reservations he or she has regarding compliance with applicable laws and regulations.

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With Circular A-133

Report Requirements

10.46 The basic elements of the auditor's standard report on compliance with requirements applicable to each major program and on the internal control over compliance (see paragraph 4.12) in accordance with Circular A-133 are—

- a.* A statement that the auditor has audited the compliance of the auditee with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that are applicable to each of its major programs.
- b.* A statement that the auditee's major programs are identified in the summary of the auditor's results section of the accompanying schedule of findings and questioned costs (see paragraph 10.56).
- c.* A statement that compliance with the requirements of laws, regulations, contracts, and grants applicable to each of the auditee's major federal programs is the responsibility of the auditee's management,

and that the auditor's responsibility is to express an opinion on the auditee's compliance based on the audit.

- d. A statement that the audit of compliance was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards), the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States,²¹ and Circular A-133.
- e. A statement that those standards and Circular A-133 require that the auditor plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that could have a direct and material effect on a major federal program occurred.
- f. A statement that an audit includes the examining, on a test basis, evidence about the auditee's compliance with those requirements and performing of such other procedures as the auditor considered necessary in the circumstances.
- g. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.
- h. A statement that the audit does not provide a legal determination of the auditee's compliance with those requirements.
- i. If instances of noncompliance are noted that result in an opinion modification, a reference to a description in the accompanying schedule of findings and questioned costs, including—
 - The reference number(s) of the finding(s).
 - An identification of the type(s) of compliance requirements and related major program(s).
 - A statement that compliance with such requirements is necessary, in the auditor's opinion, for the auditee to comply with the requirements applicable to the program(s).
- j. An opinion on whether the auditee complied, in all material respects, with the types of compliance requirements that are applicable to each of its major federal programs.
- k. If applicable, a statement that the results of the auditing procedures disclosed instances of noncompliance that are required to be reported in accordance with Circular A-133 and a reference to the schedule of findings and questioned costs in which they are described.²²
- l. A statement that the auditee's management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs.
- m. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over compliance with requirements that could have a direct and material effect on a major

²¹ See footnote 3.

²² See paragraph 10.63 for a discussion of the audit findings that are required to be reported under Circular A-133.

federal program, to determine the auditing procedures for the purpose of expressing an opinion on compliance and to test and report on the internal control over compliance in accordance with Circular A-133.

- n. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- o. If applicable, a reference to a description of reportable conditions noted in the accompanying schedule of findings and questioned costs, including the reference number of the finding(s).
- p. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- q. The definition of a material weakness.
- r. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, a reference to a description of the material weaknesses in the schedule of findings and questioned costs, including the reference number of the finding(s). If there are no reportable conditions, a statement is made that no material weaknesses were noted.
- s. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.²³
- t. The manual or printed signature of the auditor's firm.
- u. The date of the auditor's report.

Option to Report on the Schedule of Expenditures of Federal Awards

10.47 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, in certain circumstances (for example, when a separate single-audit package is issued), the required reporting on the schedule may be incorporated into the report described in paragraph 10.46. See paragraph 10.36 for a further discussion. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate this reporting option.

No Requirement to Refer to Management Letter

10.48 It is important to note that all audit findings required to be reported under Circular A-133 must be included in the schedule of findings and questioned costs (see paragraphs 10.55 and 10.56). A separate letter (that is,

²³ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

management letter) may not be used to communicate such matters to top management in lieu of reporting them as audit findings in accordance with Circular A-133. Since all reportable findings are included in the schedule, there is no requirement for the auditor to refer to the management letter in the report described in paragraph 10.46.

10.49 An example of the auditor's report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133 is presented in examples 3, 3a, 4, and 5 of appendix D.

Other Reporting Considerations

Dating of Reports

10.50 Since the report on the supplementary schedule of expenditures of federal awards indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as that on the report on these statements. Furthermore, since the report on compliance and internal control over financial reporting, as required by *Government Auditing Standards*, relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should also carry the same date.

10.51 The auditor's report on compliance and on the internal control over compliance related to major programs, as required by Circular A-133, should ordinarily have the same date as that of the other reports, but may carry a later date, because some of the audit work to satisfy Circular A-133 requirements may be done subsequent to the work on the financial statements. When this is the case, the reporting required by Circular A-133 should be dated at the later date (that is, when the fieldwork required to support the report on the audit of compliance is completed). The auditor should perform subsequent events procedures from the date of the report on the financial statements to the date of the report on the compliance audit in accordance with SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). If, after issuing the report on the financial statements, the auditor becomes aware of instances of noncompliance that could be material to such statements, he or she should follow the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 561).

10.52 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, as noted in paragraphs 10.36 and 10.47, there may be circumstances in which the auditor reports on the schedule in the report on compliance and the internal control over compliance issued to meet Circular A-133 requirements. In this situation, the report issued to meet Circular A-133 requirements must be dated the same as the report on the financial statements. This is because the report on the schedule is "in relation to" the basic financial statements. If using the same date is not possible because the work to satisfy Circular A-133 requirements is not complete as of the date of the financial statement report, the auditor has two options:

- a. The auditor can dual date the report issued to meet Circular A-133 requirements. The date relating to the portion of the report pertain-

ing to the schedule of expenditures of federal awards would be the same as the date of the financial statement report. The date pertaining to the remainder of the report would be the date on which the work done to satisfy Circular A-133 requirements is completed. Refer to SAS No. 1, section 530 *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530).

- b. The auditor can issue a separate report on the schedule of expenditures of federal awards, dated the same date as that of the financial statement report.

In some instances, the auditor may be engaged to issue a stand-alone opinion on the schedule either as part of the report issued to meet the requirements of Circular A-133 or separately (dated the same as the Circular A-133 report). The auditor should follow the guidance in SAS No. 58 when issuing such a report.

Other Auditors

10.53 When more than one independent auditor is involved in a single audit performed under Circular A-133, the auditor should refer to guidance in paragraphs 12 and 13 of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.12 and .13) regarding an opinion on financial statements based in part on the report of another auditor, as well as SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543).

When the Audit of Federal Awards Does Not Encompass the Entirety of the Auditee's Operations

10.54 If the audit of federal awards did not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph following the first paragraph of the report on major programs (see also the discussion in paragraph 3.27). An example of such a paragraph follows:

Example Entity's general-purpose financial statements include the operations of the [identify component unit or department], which received [include dollar amount] in federal awards which is not included in schedule during the year ended June 30, 20X1. Our audit, described below, did not include the operations of [identify component unit or department] because [state the reason for the omission, such as the component unit engaged other auditors to perform an audit in accordance with OMB Circular A-133].

Schedule of Findings and Questioned Costs

10.55 Circular A-133 requires the auditor to prepare a schedule of findings and questioned costs, which should include the following three sections:

- a. A summary of the auditor's results
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards*
- c. Findings and questioned costs for federal awards

What Should Be Reported

10.56 Specifically, Circular A-133 requires the schedule of findings and questioned costs to contain—

- a. A summary of the auditor's results, which must include—

- The type of report the auditor issued on the financial statements of the auditee (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.²⁴
 - A statement on whether the audit disclosed any noncompliance that is material to the financial statements of the auditee.
 - Where applicable, a statement that reportable conditions in the internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.²⁵
 - The type of report the auditor issued on compliance for major programs (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - A statement on whether the audit disclosed any audit findings that the auditor is required to report under section 510(a) of Circular A-133 (see paragraph 10.63).
 - An identification of major programs.
 - The dollar threshold used to distinguish between type A and type B programs as described in section 520(b) of Circular A-133 (see paragraphs 7.4 through 7.9).
 - A statement on whether the auditee qualified as a low-risk auditee under section 530 of Circular A-133 (see paragraph 7.25).
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards* (see the discussion in paragraphs 10.57 through 10.62 for further detail).
- c. Findings and questioned costs for federal awards, which must include audit findings as defined in section 510(a) of Circular A-133 (see paragraph 10.63). Circular A-133 also requires the following with regard to this section of the schedule:
- Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by federal agency or pass-through entity.
 - Audit findings that relate to both the financial statements and the federal awards should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form, with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that affects the auditee as a whole, including its federal awards, should usually be reported in detail

²⁴ Auditors should note that SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, precludes an auditor from issuing a written report representing that no reportable conditions were noted during an audit. Therefore, the sample schedule of findings and questioned costs included in appendix E uses the term "none reported" to indicate that no reportable conditions were included in the auditor's report (versus "none," which would imply that there were no reportable conditions).

²⁵ See footnote 24.

in the section of the schedule of findings and questioned costs that is related to the financial statements, with a summary identification and reference given in the section related to federal awards. Conversely, a finding of noncompliance with a federal program law that is also material to the financial statements should be reported in detail in the federal awards section of the schedule, with a summary identification and reference given in the financial statement section.

Findings Relating to the Financial Statements

10.57 As noted before, Circular A-133 requires the schedule of findings and questioned costs to include a section that reports the findings relating to the financial statements (note that these findings must also be addressed in the auditor's report issued to meet the requirements of *Government Auditing Standards*—see paragraphs 10.15, 10.16, and 10.21 through 10.30). This section of the schedule should include all reportable conditions in the internal control over financial reporting and other findings relative to the audit of the financial statements that are required to be reported by GAAS and *Government Auditing Standards*, including those that do not affect federal awards. In addition to requiring auditors to report reportable conditions in the internal control over financial reporting, *Government Auditing Standards* requires auditors to report all but clearly inconsequential fraud and illegal acts that the auditor concludes, based on the evidence obtained, either occurred or are likely to have occurred. *Government Auditing Standards* also requires the auditor to report other noncompliance (for example, violations of the provisions of contract or grant agreements) that is material to the financial statements (see paragraphs 10.21 and 10.22).

10.58 In reporting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should place their findings in proper perspective. This perspective is both quantitative and qualitative. To give the reader a basis to judge the prevalence and consequences of these conditions, the instances that are identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. Reportable conditions that are—either individually or in the aggregate—material weaknesses should be so identified.

10.59 *Government Auditing Standards* suggests that well-developed findings generally include the following elements:

- Criteria (what should be)
- The condition (what is)
- The effect (the difference between what is and what should be)
- The cause (why it happened)

10.60 *Government Auditing Standards* recognizes reportable conditions and noncompliance identified by the auditor may not always have all of the elements fully developed. However, to provide sufficient information to users to permit them to determine the effect and cause in order to take prompt and proper corrective action, auditors should identify at least the criteria, condition, and possible asserted effect.

10.61 In presenting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should follow the report content standards in chapter 7 of *Government Auditing Standards* that pertain to objectives, scope, and

methodology; audit results; the views of responsible officials; and the reports presentation standards (as appropriate). Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.

10.62 *Government Auditing Standards* also requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit (see paragraph 6.65 for a discussion of the auditor's responsibility for audit follow-up under *Government Auditing Standards*). The auditor should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. Material findings and recommendations from previous audits that are repeated as current-year findings should be identified as repeat findings. If there are uncorrected findings from previous audits that are not repeated as current-year findings, their status should also be reported by the auditor. In either case, this information should be provided for in the section of the schedule of findings and questioned costs related to the financial statements.

Audit Findings Reported—Federal Awards

10.63 Section 510(a) of Circular A-133 requires the auditor to report as audit findings in the schedule of findings and questioned costs—

- a. Reportable conditions in the internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or to an audit objective identified in the *Compliance Supplement*. The auditor should identify reportable conditions that are individually or cumulatively material weaknesses (see paragraphs 8.25 and 8.26).
- b. Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements that are related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement* (see paragraphs 6.51 through 6.60 for a further discussion of the evaluation and reporting of noncompliance).
- c. Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor should consider the best estimate of the total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor should also report (in the schedule of findings and questioned costs) known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, estimates that the

total questioned costs are in the \$50,000–\$60,000 range, the auditor should report a finding that identifies the known questioned costs of \$7,000. Although the auditor is not required to report his or her estimate of the total questioned costs, the auditor should include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- d. Known questioned costs that are greater than \$10,000 for programs that are not audited as major. Since (except for audit follow-up) the auditor is not required to perform audit procedures for federal programs that are not major, the auditor will normally not find questioned costs. However, if the auditor does become aware of questioned costs for a federal program that is not audited as a major program (for example, as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor should report this as an audit finding.
- e. The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for federal awards (for example, a scope limitation that is not otherwise reported as a finding).
- f. Known fraud affecting a federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards* (see paragraphs 10.23 through 10.25).
- g. Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with section 315(b) of Circular A-133 materially misrepresents the status of any prior audit finding (see paragraphs 10.68 through 10.70).

Detail of Audit Findings—Federal Awards

10.64 Section 510(b) of Circular A-133 requires that audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for federal agencies and pass-through entities to arrive at a management decision. The specific information that Circular A-133 requires in audit findings consists of (as applicable)—

- a. Identification of the federal program and specific federal award including the CFDA title and number, the federal award number and year, the name of federal agency, and the name of the applicable pass-through entity. When information such as the CFDA title and number or the federal award number is not available, the auditor should provide the best information available to describe the federal award.
- b. The criteria or specific requirement upon which the audit finding is based, including the statutory, regulatory, or other citation.
- c. The condition found, including facts that support the deficiency identified in the audit finding.
- d. Identification of questioned costs and how they were computed.

- e. Information to provide a proper perspective for judging the prevalence and consequences of the audit findings, (for example, whether the audit findings represent an isolated instance or a systemic problem). Where appropriate, the instances identified should be related to the universe and the number of cases examined and be quantified in terms of the dollar value.
- f. The possible asserted effect to provide sufficient information to the auditee and federal agency (or pass-through entity, in the case of a subrecipient) to permit them to determine the cause and effect, to facilitate prompt and proper corrective action.
- g. Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- h. To the extent practical, the views of responsible officials of the auditee when there is disagreement with the audit findings. If the auditee's corrective action plan is available and contains the views of the responsible officials, the auditor can indicate in the finding that the auditee disagreed with the finding and refer to the details of the auditee's position in the corrective action plan. However, if the auditor does not agree with the auditee's position, the auditor should state his or her reasons for rejecting it.

Other Preparation Guidance

10.65 Each audit finding in the schedule of findings and questioned costs should include a reference number to allow for easy referencing of the audit findings during follow-up. One option for assigning reference numbers is to use the last two digits of the fiscal year being audited as the first two digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 20X1 would be assigned reference numbers 20X1-1, 20X1-2, etc.

10.66 A schedule of findings and questioned costs must be issued for every single audit, regardless of whether any findings or questioned costs are noted. This is because Circular A-133 requires that one section of the schedule summarize the audit results (see paragraphs 10.55 and 10.56). In a situation in which there are no findings or questioned costs, the auditor should prepare the summary of auditor's results section of the schedule and indicate in the other required sections that no matters were reportable.

10.67 Appendix E contains an illustrative schedule of findings and questioned costs.

Summary Schedule of Prior Audit Findings and Corrective Action Plan

10.68 The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee is required to prepare a summary schedule of prior audit findings. The auditee is not required to prepare a summary schedule of prior audit findings if there are no matters reportable therein. The auditee is also required to prepare a corrective action plan for each of the current-year audit findings. The summary schedule of prior audit findings and the corrective action plan, which are both part of the reporting package, must include the reference numbers the auditor assigns to audit findings in the schedule of findings and questioned costs. This numbering

(or other identification) should include the fiscal year in which the finding initially occurred.

10.69 The auditor is required to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of section 500(e) of Circular A-133 (see paragraphs 6.61 through 6.65).

10.70 The auditor has no responsibility for the corrective action plan; however, the auditor may be separately engaged by the auditee for assistance in developing appropriate corrective actions in response to audit findings. The auditor may find the auditee's corrective action plan useful in performing follow-up on prior audit findings (in addition to the schedule of prior audit findings), because it may provide an indication of the corrective steps planned by the auditee.

Data Collection Form

10.71 Circular A-133 requires the auditee to complete and sign certain sections of a data collection form that states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. This form is not part of the reporting package (see paragraph 10.7). The information required to be included in the form, however, represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards.

10.72 The auditor is also required to complete certain sections of the form, including information on the auditor and information on the results of the financial statement audit and the audit of federal programs. The auditor is also required to sign a statement in the form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package, and that the content of the form is limited to the data elements prescribed by the OMB. As part of completing the form, the auditor is asked to date it. The date that is entered by the auditor should be the date on which he or she completes and signs the form. The wording of the auditor's statement section of the form indicates that no additional procedures were performed since the date of the audit reports. This wording alleviates the auditor from any subsequent-event responsibility with regard to the timing of the completion of the form and the completion of the audit. The form includes detailed instructions, which should be carefully followed by the auditor.

10.73 The data collection form and related instructions can be obtained from the Federal Audit Clearinghouse's home page at harvester.census.gov/sac or by calling the Clearinghouse at (888) 222-9907. The form number is SF-SAC.²⁶

²⁶ It should be noted that the Federal Audit Clearinghouse (FAC) is able to accept the data collection form via an online Internet Data Entry System (IDES). The main benefit of using the IDES is that an edit function built directly into the FAC's system identifies certain errors that may have been made in completing the form. This allows both auditors and auditees to correct these errors prior to submitting the form. Once the form is completed and has passed all of the edits, the entity is able to submit the data electronically. The IDES then allows the entity to print a hard copy of the form to be signed by both the auditor and auditee and sent to the FAC along with the appropriate number of reporting packages. The FAC home page at <http://harvester.census.gov/sac/> includes instructions on how to complete the online Internet submission.

Submission of Reporting Package and Data Collection Form

10.74 The submission of the data collection form and the reporting package, including the audit reports, is the responsibility of the auditee. The data collection form and the reporting package must be submitted by the auditee within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. However, it should be noted that Circular A-133 includes a delayed implementation date for report-submission deadlines. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and reporting package must be submitted within thirty days after the receipt of the auditor's reports, or thirteen months after the end of the audit period.

Submission to Clearinghouse

10.75 All auditees must submit to the federal clearinghouse designated by the OMB the data collection form and one copy of the reporting package (see paragraph 10.6 for a description) for (a) the federal clearinghouse to retain as an archival copy and (b) each federal awarding agency, when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the federal awarding agency provided directly or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the federal awarding agency provided directly.

Submission by Subrecipients

10.76 In addition to the requirements in paragraph 10.75, auditees that are also subrecipients must submit to each pass-through entity one copy of the reporting package for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the pass-through entity provided or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the pass-through entity provided. When a subrecipient is not required to submit a reporting package to a pass-through entity, the subrecipient must instead provide written notification to the pass-through entity that—

- An audit of the subrecipient was conducted in accordance with Circular A-133 (including the period covered by the audit and the name, amount, and CFDA number of the federal awards provided by the pass-through entity).
- The schedule of findings and questioned costs disclosed no audit findings relating to the federal awards that the pass-through entity provided.
- The summary schedule of prior audit findings did not report on the status of any audit findings relating to the federal awards that the pass-through entity provided.

A subrecipient may submit a copy of the reporting package to a pass-through entity to comply with this notification.

Requests for Copies

10.77 In response to a request by a federal agency or pass-through entity, auditees should submit the appropriate copies of the reporting package and, if requested, a copy of any management letters issued by the auditor.

Report Retention Requirements

10.78 Auditees are required to keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse designated by the OMB. Pass-through entities should keep subrecipients' submissions on file for three years from the date of receipt.

Clearinghouse Address

10.79 The name and address of the federal clearinghouse currently designated by the OMB are as follows: Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th St., Jeffersonville, IN 47132.

Freedom of Information Act

10.80 In accordance with the principles of the Freedom of Information Act (U.S. Code title 5, section 552), audit agency and nonfederal reports issued to grantees and contractors are available, if they are requested, to members of the press and the general public, to the extent that the information contained in them is not subject to exemptions of the act that the cognizant agency for audit chooses to exercise. Accordingly, the auditor should not include names, social security numbers, other personal identification, or other potentially sensitive matters in either the body of the report or any attached schedules.

Chapter 11

PROGRAM-SPECIFIC AUDITS

11.1 A program-specific audit is an audit of an individual federal program (rather than a single audit of an entity's financial statements and federal programs). Section 235 of Circular A-133 provides guidance on program-specific audits.

Use of a Program-Specific Audit to Satisfy Circular A-133 Audit Requirements

11.2 Circular A-133 states that when an auditee expends federal awards under only one federal program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit performed in accordance with section 235 of the circular.¹ Therefore, the auditor should determine whether there is a financial statement audit requirement before performing a program-specific audit. A program-specific audit may not be elected for research and development unless all federal awards expended were received from the same federal agency (or the same federal agency and the same pass-through entity) and that federal agency (or pass-through entity, in the case of a subrecipient) approves a program-specific audit in advance.

Program-Specific Audit Requirements

11.3 Circular A-133 requires program-specific audits to be subject to the following sections of Circular A-133 as they may apply to program-specific audits, unless contrary to the provisions of section 235 of Circular A-133, a federal program-specific audit guide, or the program's laws and regulations:

- Purpose; definitions; audit requirements; basis for determining the federal awards expended; subrecipient and vendor determinations; relation to other audit requirements (sections 100 through 215(b))
- Frequency of audits; sanctions; audit costs (sections 220 through 230)
- Auditee responsibilities; auditor selection (sections 300 through 305)
- Follow-up on audit findings (section 315)
- Submission of report (sections 320(f) through 320(j))
- Responsibilities of federal agencies and pass-through entities; management decisions (sections 400 through 405)
- Audit findings and audit working papers (sections 510 through 515)

Program-specific audits are also subject to other provisions, referred to in section 235 of the circular.

¹ An example of a situation where a program-specific audit would not be allowed would be a not-for-profit college that receives SFA (and no other federal awards). This is because the Higher Education Act of 1965, as amended, requires institutions that receive SFA to undergo an annual financial statement audit.

Availability of Program-Specific Audit Guides

11.4 In many cases, a federal agency's Office of Inspector General will have issued a program-specific audit guide that provides guidance on internal control, compliance requirements, suggested audit procedures, and audit reporting requirements for a particular federal program. The auditor should contact the Office of Inspector General of the federal agency to determine whether such a guide is available and current. When a current program-specific audit guide is available, the auditor should follow *Government Auditing Standards* and the guide when performing a program-specific audit. However, if there have been significant changes made to a program's compliance requirements and the related program-specific audit guide has not been updated with regard to the changes, the auditor should follow section 235 of Circular A-133 and the *Compliance Supplement* in lieu of an outdated guide. If a guide is current with regard to a program's compliance requirements but has not been updated to conform to current authoritative standards and guidance (such as current revisions of GAAS or *Government Auditing Standards*), the auditor should follow current applicable professional standards and guidance in lieu of the outdated or inconsistent standards and guidance in the guide.

11.5 When a program-specific audit guide is not available, the auditee and the auditor have basically the same responsibilities for the federal program as they have for an audit of a major program in a single audit as discussed in chapters 6 and 8 of this SOP.

Auditee's Responsibilities When a Program-Specific Audit Guide is Not Available

11.6 In addition to having the responsibilities included in the sections of Circular A-133 that are described in paragraph 11.3, the auditee is required to prepare the following:

- The financial statements for the federal program, which include, at a minimum, a schedule of expenditures of federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule
- A summary schedule of prior audit findings consistent with the requirements of section 315(b) of Circular A-133 (see paragraphs 10.68 through 10.70)
- If applicable, a corrective action plan consistent with the requirements of section 315(c) of the circular (see paragraphs 10.68 through 10.70)

Auditor's Responsibilities When a Program-Specific Audit Guide is Not Available

Audit Scope and Requirements

11.7 Circular A-133 requires the auditor to—

- Perform an audit of the financial statement(s) for the federal program in accordance with *Government Auditing Standards* (see chapter 4 of this SOP for guidance on financial statement audits). See paragraph 11.10 for a further discussion of *Government Auditing Standards*.

- Obtain an understanding of the internal control over compliance and perform tests of the internal control over compliance for the federal program, so that they are consistent with the requirements of section 500(c) of the circular for a major program (see chapter 8 of this SOP for guidance on the internal control considerations for major programs).
- Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program consistent with the requirements of section 500(d) of the circular for a major program (see chapter 6 of this SOP for guidance on the compliance-auditing considerations for major programs).
- Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings that has been prepared by the auditee, and when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding, report this as a current-year audit finding, in accordance with the requirements of section 500(e) of the circular (see paragraphs 10.69 through 10.70).

Auditor's Reports

Circular A-133 Requirements

11.8 Circular A-133 states that the auditor's reports may be in the form of either combined or separate reports and may be organized differently from the manner described below. The auditor's reports should state that the audit was conducted in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards*, and Circular A-133 and should include the following:

- An opinion (or disclaimer of opinion) on whether the financial statement(s) of the federal program are presented fairly in all material respects in conformity with the stated accounting policies
- A report on the internal control related to the federal program, which describes the scope of the testing of the internal control and the results of the tests
- A report on compliance, which includes an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program
- A schedule of findings and questioned costs for the federal program, which includes a summary of the auditor's results relative to the audit of the federal program in a format consistent with the requirements for the summary of auditor's results in section 505(d)(1) of the circular, as well as findings and questioned costs for federal awards consistent with the requirements of section 505(d)(3) of the circular (see paragraph 10.55 and 10.56)

Recommended Auditor's Reports

11.9 In an effort to make program-specific audit reporting understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a program-specific audit (a) an opinion on the financial statement(s) of the federal program and (b) a report on compliance

with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under OMB Circular A-133. See the following paragraph for a discussion of the possible issuance of a third report to meet the reporting requirements of *Government Auditing Standards*. Illustrations of program-specific audit reports are included in examples 6 and 6a of appendix D.

Reporting in Accordance With Government Auditing Standards

11.10 If the financial statement(s) of the program only present the activity of the federal program, the auditor is not required to issue a separate report to meet the reporting requirements of *Government Auditing Standards*. This is because, in many cases, by definition the financial statements of the program consist only of the schedule of expenditures of federal awards. In this situation, examples 6 and 6a of appendix D, would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133. However, it should be noted that the auditor always has the option of issuing a separate *Government Auditing Standards* report (in addition to the two reports described in paragraph 11.9). Although it is not as common, the financial statement(s) of the federal program may present more than the program's activity (for example, a municipal sewer district issues financial statements that include both normal operations and the federal program activity related to a grant for the purpose of building a new sewage-treatment facility). In this situation, the auditor should issue a separate *Government Auditing Standards* report (example 2 or 2a of appendix D), and modify it so that it refers only to the financial statement(s) of the federal program.

Submission of Report

Timing of Submission

11.11 Circular A-133 requires the audit to be completed and the reporting required by sections 235(c)(2) and 235(c)(3) of the circular to be submitted, within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the federal agency that provided the funding or unless a different period is specified in a program-specific audit guide.^[2] Unless restricted by law or regulation, Circular A-133 requires the auditee to make copies of the report available for public inspection.

Submission When a Program-Specific Audit Guide is Available

11.12 When a program-specific audit guide is available, the auditee must submit to the federal clearinghouse designated by the OMB (see paragraph 10.79) the data collection form prepared in accordance with section 320(b) of the Circular (see paragraphs 10.71 through 10.73), as applicable for a program-specific audit, and must also submit the reporting that is required by the program-specific audit guide which is to be retained as an archival copy. The auditee must also submit to the federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

^[2] [Deleted.]

Submission When a Program-Specific Audit Guide is Not Available

11.13 When a program-specific audit guide is not available, the reporting package for a program-specific audit consists of the following:

- The financial statement(s) of the federal program
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70)
- A corrective action plan (see paragraphs 10.68 through 10.70)
- The auditor's report(s) described in paragraphs 11.8 through 11.10

11.14 The data collection form, as applicable to a program-specific audit, and one copy of the reporting package must be submitted to the federal clearinghouse designated by the OMB (see paragraph 10.79), to be retained as an archival copy. Furthermore, when the schedule of findings and questioned costs discloses audit findings or the summary schedule of prior audit findings reports the status of any audit findings, the auditee must submit one copy of the reporting package to the federal clearinghouse on behalf of the federal awarding agency or, in the case of a subrecipient, directly to the pass-through entity. When a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient is instead required to provide written notification to the pass-through entity, consistent with the requirements of section 320(e)(2) of Circular A-133 (see paragraph 10.76). A subrecipient may submit a copy of the reporting package to the pass-through entity, to comply with the notification requirement.

APPENDIX A

Single Audit Act Amendments of 1996

Public Law 104-156
104th Congress

An Act

July 5, 1996 To streamline and improve the effectiveness of chapter 75 of title 31, United States Code
[S. 1579] (commonly referred to as the "Single Audit Act").

Single Audit Act
Amendments of
1996.
31 USC 7501
note.

*Be it enacted by the Senate and House of Representatives of the
United States of America in Congress assembled,*

SECTION 1. SHORT TITLE; PURPOSES.

(a) **SHORT TITLE**—This Act may be cited as the "Single Audit Act
Amendments of 1996".

(b) **PURPOSES**—The purposes of this Act are to—

- (1) promote sound financial management, including effective internal controls, with respect to Federal awards administered by non-Federal entities;
- (2) establish uniform requirements for audits of Federal awards administered by non-Federal entities;
- (3) promote the efficient and effective use of audit resources;
- (4) reduce burdens on State and local governments, Indian tribes, and nonprofit organizations; and
- (5) ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as amended by this Act).

SEC. 2. AMENDMENT TO TITLE 31, UNITED STATES CODE.

Chapter 75 of title 31, United States Code, is amended to read as follows:

"CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS

"Sec.

- "7501. Definitions.
- "7502. Audit requirements; exemptions.
- "7503. Relation to other audit requirements.
- "7504. Federal agency responsibilities and relations with non-Federal entities.
- "7505. Regulations.
- "7506. Monitoring responsibilities of the Comptroller General.
- "7507. Effective date.

"§ 7501. Definitions

"(a) As used in this chapter, the term—

- "(1) 'Comptroller General' means the Comptroller General of the United States;
- "(2) 'Director' means the Director of the Office of Management and Budget;
- "(3) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5;
- "(4) 'Federal awards' means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities;

"(5) 'Federal financial assistance' means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director;

"(6) 'Federal program' means all Federal awards to a non-Federal entity assigned a single number in the Catalog of Federal Domestic Assistance or encompassed in a group of numbers or other category as defined by the Director;

"(7) 'generally accepted government auditing standards' means the government auditing standards issued by the Comptroller General;

"(8) 'independent auditor' means—

"(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards; or

"(B) a public accountant who meets such independence standards;

"(9) 'Indian tribe' means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians;

"(10) 'internal controls' means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

"(A) Effectiveness and efficiency of operations.

"(B) Reliability of financial reporting.

"(C) Compliance with applicable laws and regulations;

"(11) 'local government' means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, any other instrumentality of local government and, in accordance with guidelines issued by the Director, a group of local governments;

"(12) 'major program' means a Federal program identified in accordance with risk-based criteria prescribed by the Director under this chapter, subject to the limitations described under subsection (b);

"(13) 'non-Federal entity' means a State, local government, or nonprofit organization;

"(14) 'nonprofit organization' means any corporation, trust, association, cooperative, or other organization that—

"(A) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

"(B) is not organized primarily for profit; and

"(C) uses net proceeds to maintain, improve, or expand the operations of the organization;

“(15) ‘pass-through entity’ means a non-Federal entity that provides Federal awards to a subrecipient to carry out a Federal program;

“(16) ‘program-specific audit’ means an audit of one Federal program;

“(17) ‘recipient’ means a non-Federal entity that receives awards directly from a Federal agency to carry out a Federal program;

“(18) ‘single audit’ means an audit, as described under section 7502(d), of a non-Federal entity that includes the entity’s financial statements and Federal awards;

“(19) ‘State’ means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe; and

“(20) ‘subrecipient’ means a non-Federal entity that receives Federal awards through another non-Federal entity to carry out a Federal program, but does not include an individual who receives financial assistance through such awards.

“(b) In prescribing risk-based program selection criteria for major programs, the Director shall not require more programs to be identified as major for a particular non-Federal entity, except as prescribed under subsection (c) or as provided under subsection (d), than would be identified if the major programs were defined as any program for which total expenditures of Federal awards by the non-Federal entity during the applicable year exceed—

“(1) the larger of \$30,000,000 or 0.15 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$10,000,000,000;

“(2) the larger of \$3,000,000, or 0.30 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$100,000,000 but are less than or equal to \$10,000,000,000; or

“(3) the larger of \$300,000, or 3 percent of such total Federal expenditures for all programs, in the case of a non-Federal entity for which such total expenditures for all programs equal or exceed \$300,000 but are less than or equal to \$100,000,000.

“(c) When the total expenditures of a non-Federal entity’s major programs are less than 50 percent of the non-Federal entity’s total expenditures of all Federal awards (or such lower percentage as specified by the Director), the auditor shall select and test additional programs as major programs as necessary to achieve audit coverage of at least 50 percent of Federal expenditures by the non-Federal entity (or such lower percentage as specified by the Director), in accordance with guidance issued by the Director.

“(d) Loan or loan guarantee programs, as specified by the Director, shall not be subject to the application of subsection (b).

“§ 7502. Audit requirements; exemptions

“(a)(1)(A) Each non-Federal entity that expends a total amount of Federal awards equal to or in excess of \$300,000 or such other amount

specified by the Director under subsection (a)(3) in any fiscal year of such non-Federal entity shall have either a single audit or a program-specific audit made for such fiscal year in accordance with the requirements of this chapter.

“(B) Each such non-Federal entity that expends Federal awards under more than one Federal program shall undergo a single audit in accordance with the requirements of subsections (b) through (i) of this section and guidance issued by the Director under section 7505.

“(C) Each such non-Federal entity that expends awards under only one Federal program and is not subject to laws, regulations, or Federal award agreements that require a financial statement audit of the non-Federal entity, may elect to have a program-specific audit conducted in accordance with applicable provisions of this section and guidance issued by the Director under section 7505.

“(2)(A) Each non-Federal entity that expends a total amount of Federal awards of less than \$300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such entity, shall be exempt for such fiscal year from compliance with—

“(i) the audit requirements of this chapter; and

“(ii) any applicable requirements concerning financial audits contained in Federal statutes and regulations governing programs under which such Federal awards are provided to that non-Federal entity.

“(B) The provisions of subparagraph (A)(ii) of this paragraph shall not exempt a non-Federal entity from compliance with any provision of a Federal statute or regulation that requires such non-Federal entity to maintain records concerning Federal awards provided to such non-Federal entity or that permits a Federal agency, pass-through entity, or the Comptroller General access to such records.

“(3) Every 2 years, the Director shall review the amount for requiring audits prescribed under paragraph (1)(A) and may adjust such dollar amount consistent with the purposes of this chapter, provided the Director does not make such adjustments below \$300,000.

“(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

“(2) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(3) Any nonprofit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally

accepted government auditing standards, except that, for the purposes of this chapter, performance audits shall not be required except as authorized by the Director.

“(d) Each single audit conducted pursuant to subsection (a) for any fiscal year shall—

“(1) cover the operations of the entire non-Federal entity; or

“(2) at the option of such non-Federal entity such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and organizational unit, which shall be considered to be a non-Federal entity.

“(e) The auditor shall—

“(1) determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

“(2) determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole;

“(3) with respect to internal controls pertaining to the compliance requirements for each major program—

“(A) obtain an understanding of such internal controls;

“(B) assess control risk; and

“(C) perform tests of controls unless the controls are deemed to be ineffective; and

“(4) determine whether the non-Federal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to Federal awards that have a direct and material effect on each major program.

“(f)(1) Each Federal agency which provides Federal awards to a recipient shall—

“(A) provide such recipient the program names (and any identifying numbers) from which such awards are derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter; and

“(B) review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency.

“(2) Each pass-through entity shall—

“(A) provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

“(B) monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

“(C) review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

“(D) require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient’s records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

“(g)(1) The auditor shall report on the results of any audit conducted pursuant to this section, in accordance with guidance issued by the Director. Reports.

“(2) When reporting on any single audit, the auditor shall include a summary of the auditor’s results regarding the non-Federal entity’s financial statements, internal controls, and compliance with laws and regulations.

“(h) The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity’s financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditor’s reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of—

“(1) 30 days after receipt of the auditor’s report; or

“(2)(A) for a transition period of at least 2 years after the effective date of the Single Audit Act Amendments of 1996, as established by the Director, 13 months after the end of the period audited; or

“(B) for fiscal years beginning after the period specified in subparagraph (A), 9 months after the end of the period audited, or within a longer time frame authorized by the Federal agency, determined under criteria issued under section 7504, when the 9-month time frame would place an undue burden on the non-Federal entity.

“(i) If an audit conducted pursuant to this section discloses any audit findings, as defined by the Director, including material noncompliance with individual compliance requirements for a major program by, or reportable conditions in the internal controls of, the non-Federal entity with respect to the matters described in subsection (e), the non-Federal entity shall submit to Federal officials designated by the Director, a plan for corrective action to eliminate such audit findings or reportable conditions or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(c).

“(j) The Director may authorize pilot projects to test alternative methods of achieving the purposes of this chapter. Such pilot projects may begin only after consultation with the Chair and Ranking Minority Member of the Committee on Governmental Affairs of the Senate and the Chair and Ranking Minority Member of the Committee on Government Reform and Oversight of the House of Representatives.

§ 7503. Relation to other audit requirements

“(a) An audit conducted in accordance with this chapter shall be in lieu of any financial audit of Federal awards which a non-Federal entity is required to undergo under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal

law or regulation, a Federal agency shall rely upon and use that information.

“(b) Notwithstanding subsection (a), a Federal agency may conduct or arrange for additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any non-Federal entity (or subrecipient thereof) to constrain, in any manner, such agency from carrying out or arranging for such additional audits, except that the Federal agency shall plan such audits to not be duplicative of other audits of Federal awards.

“(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or arrange for the conduct of, audits and evaluations of Federal awards, nor limit the authority of any Federal agency Inspector General or other Federal official.

“(d) Subsection (a) shall apply to a non-Federal entity which undergoes an audit in accordance with this chapter even though it is not required by section 7502(a) to have such an audit.

“(e) A Federal agency that provides Federal awards and conducts or arranges for audits of non-Federal entities receiving such awards that are in addition to the audits of non-Federal entities conducted pursuant to this chapter shall, consistent with other applicable law, arrange for funding the full cost of such additional audits. Any such additional audits shall be coordinated with the Federal agency determined under criteria issued under section 7504 to preclude duplication of the audits conducted pursuant to this chapter or other additional audits.

“(f) Upon request by a Federal agency or the Comptroller General, any independent auditor conducting an audit pursuant to this chapter shall make the auditor’s working papers available to the Federal agency or the Comptroller General as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this chapter. Such access to auditor’s working papers shall include the right to obtain copies.

“§ 7504. Federal agency responsibilities and relations with non-Federal entities

“(a) Each Federal agency shall, in accordance with guidance issued by the Director under section 7505, with regard to Federal awards provided by the agency—

“(1) monitor non-Federal entity use of Federal awards, and

“(2) assess the quality of audits conducted under this chapter for audits of entities for which the agency is the single Federal agency determined under subsection (b).

“(b) Each non-Federal entity shall have a single Federal agency, determined in accordance with criteria established by the Director, to provide the non-Federal entity with technical assistance and assist with implementation of this chapter.

“(c) The Director shall designate a Federal clearinghouse to—

“(1) receive copies of all reporting packages developed in accordance with this chapter;

“(2) identify recipients that expend \$300,000 or more in Federal awards or such other amount specified by the Director under section 7502(a)(3) during the recipient’s fiscal year but did not undergo an audit in accordance with this chapter; and

“(3) perform analyses to assist the Director in carrying out responsibilities under this chapter.

“§ 7505. Regulations

“(a) The Director, after consultation with the Comptroller General, and appropriate officials from Federal, State, and local governments and nonprofit organizations shall prescribe guidance to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such guidance.

“(b)(1) The guidance prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to Federal awards for the cost of audits. Such criteria shall prohibit a non-Federal entity from charging to any Federal awards—

“(A) the cost of any audit which is—

“(i) not conducted in accordance with this chapter; or

“(ii) conducted in accordance with this chapter when expenditures of Federal awards are less than amounts cited in section 7502(a)(1)(A) or specified by the Director under section 7502(a)(3), except that the Director may allow the cost of limited scope audits to monitor subrecipients in accordance with section 7502(f)(2)(B); and

“(B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

“(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit the percentage of the cost of audits performed pursuant to this chapter charged to Federal awards, to exceed the ratio of total Federal awards expended by such non-Federal entity during the applicable fiscal year or years, to such non-Federal entity’s total expenditures during such fiscal year or years.

“(c) Such guidance shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

“§ 7506. Monitoring responsibilities of the Comptroller General

“(a) The Comptroller General shall review provisions requiring financial audits of non-Federal entities that receive Federal awards that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives.

“(b) If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

“(1) the committee that reported such bill or resolution; and

“(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

“(B) the Committee on Government Reform and Oversight of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

“§ 7507. Effective date

“This chapter shall apply to any non-Federal entity with respect to any of its fiscal years which begin after June 30, 1996.”.

31 USC 7501
note.

SEC. 3. TRANSITIONAL APPLICATION

Subject to section 7507 of title 31, United States Code (as amended by section 2 of this Act) the provisions of chapter 75 of such title (before amendment by section 2 of this Act) shall continue to apply to any State or local government with respect to any of its fiscal years beginning before July 1, 1996.

Approved July 5, 1996.

LEGISLATIVE HISTORY—S. 1579 (H.R. 3184):

HOUSE REPORTS: No. 104–607 accompanying H.R. 3184 (Comm. on Government Reform and Oversight).

SENATE REPORTS: No. 104–266 (Comm. On Governmental Affairs).

CONGRESSIONAL RECORD, Vol. 142 (1996):

June 14, considered and passed Senate.

June 18, considered and passed House.

WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 32 (1996):

July 5, Presidential statement.

APPENDIX B

OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

Franklin D. Raines,
Director

1. OMB rescinds Circular A-128 July 30, 1997
2. OMB revises Circular A-133 to read as follows:

[Circular No. A-133—Revised]

To the Heads of Executive Departments and Establishments

SUBJECT: Audits of States, Local Governments, and Non-Profit Organizations.

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. It sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of States, local governments, and non-profit organizations expending Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of sections 503, 1111, and 7501 *et seq.* of title 31, United States Code, and Executive Orders 8248 and 11541.

3. *Rescission and Supersession.* This Circular rescinds Circular A-128, "Audits of State and Local Governments," issued April 12, 1985, and supersedes the prior Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions," issued April 22, 1996. For effective dates, see paragraph 10.

4. *Policy.* Except as provided herein, the standards set forth in this Circular shall be applied by all Federal agencies. If any statute specifically prescribes policies or specific requirements that differ from the standards provided herein, the provisions of the subsequent statute shall govern.

Federal agencies shall apply the provisions of the sections of this Circular to non-Federal entities, whether they are recipients expending Federal awards received directly from Federal awarding agencies, or are subrecipients expending Federal awards received from a pass-through entity (a recipient or another subrecipient).

This Circular does not apply to non-U.S. based entities expending Federal awards received either directly as a recipient or indirectly as a subrecipient.

5. *Definitions.* The definitions of key terms used in this Circular are contained in §___105 in the Attachment to this Circular.

6. *Required Action.* The specific requirements and responsibilities of Federal agencies and non-Federal entities are set forth in the Attachment to this

Circular. Federal agencies making awards to non-Federal entities, either directly or indirectly, shall adopt the language in the Circular in codified regulations as provided in Section 10 (below), unless different provisions are required by Federal statute or are approved by the Office of Management and Budget (OMB).

7. OMB Responsibilities. OMB will review Federal agency regulations and implementation of this Circular, and will provide interpretations of policy requirements and assistance to ensure uniform, effective and efficient implementation.

8. Information Contact. Further information concerning Circular A-133 may be obtained by contacting the Financial Standards and Reporting Branch, Office of Federal Financial Management, Office of Management and Budget, Washington, DC 20503, telephone (202) 395-3993.

9. Review Date. This Circular will have a policy review three years from the date of issuance.

10. Effective Dates. The standards set forth in §____.400 of the Attachment to this Circular, which apply directly to Federal agencies, shall be effective July 1, 1996, and shall apply to audits of fiscal years beginning after June 30, 1996, except as otherwise specified in §____.400(a).

The standards set forth in this Circular that Federal agencies shall apply to non-Federal entities shall be adopted by Federal agencies in codified regulations not later than 60 days after publication of this final revision in the **Federal Register**, so that they will apply to audits of fiscal years beginning after June 30, 1996, with the exception that §____.305(b) of the Attachment applies to audits of fiscal years beginning after June 30, 1998. The requirements of Circular A-128, although the Circular is rescinded, and the 1990 version of Circular A-133 remain in effect for audits of fiscal years beginning on or before June 30, 1996.

Franklin D. Raines,
Director.

Attachment

PART__—AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS**Subpart A—General**

Sec.

__.100 Purpose.

__.105 Definitions.

Subpart B—Audits

__.200 Audit requirements.

__.205 Basis for determining Federal awards expended.

__.210 Subrecipient and vendor determinations.

__.215 Relation to other audit requirements.

__.220 Frequency of audits.

__.225 Sanctions.

__.230 Audit costs.

__.235 Program-specific audits.

Subpart C—Auditees

__.300 Auditee responsibilities.

__.305 Auditor selection.

__.310 Financial statements.

__.315 Audit findings follow-up.

__.320 Report submission.

Subpart D—Federal Agencies and Pass-Through Entities

__.400 Responsibilities.

__.405 Management decision.

Subpart E—Auditors

__.500 Scope of audit.

__.505 Audit reporting.

__.510 Audit findings.

__.515 Audit working papers.

__.520 Major program determination.

__.525 Criteria for Federal program risk.

__.530 Criteria for a low-risk auditee.

Appendix A to Part__—Data Collection Form (Form SF-SAC)**Appendix B to Part__—Circular A-133 Compliance Supplement****Subpart A—General****§__.100 Purpose.**

This part sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of non-Federal entities expending Federal awards.

§ __.105 Definitions.

Auditee means any non-Federal entity that expends Federal awards which must be audited under this part.

Auditor means an auditor, that is a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in generally accepted government auditing standards (GAGAS). The term auditor does not include internal auditors of non-profit organizations.

Audit finding means deficiencies which the auditor is required by § __.510(a) to report in the schedule of findings and questioned costs.

CFDA number means the number assigned to a Federal program in the *Catalog of Federal Domestic Assistance (CFDA)*.

Cluster of programs means a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters. "Other clusters" are as defined by the Office of Management and Budget (OMB) in the compliance supplement or as designated by a State for Federal awards the State provides to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," a State shall identify the Federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with § __.400(d)(1) and § __.400(d)(2), respectively. A cluster of programs shall be considered as one program for determining major programs, as described in § __.520, and, with the exception of R&D as described in § __.200(c), whether a program-specific audit may be elected.

Cognizant agency for audit means the Federal agency designated to carry out the responsibilities described in § __.400(a).

Compliance supplement refers to the *Circular A-133 Compliance Supplement*, included as Appendix B to Circular A-133, or such documents as OMB or its designee may issue to replace it. This document is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20402-9325.

Corrective action means action taken by the auditee that:

- (1) Corrects identified deficiencies;
- (2) Produces recommended improvements; or
- (3) Demonstrates that audit findings are either invalid or do not warrant auditee action.

Federal agency has the same meaning as the term *agency* in Section 551(1) of title 5, United States Code.

Federal award means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors. Any audits of such vendors shall be covered by the terms and conditions of the contract. Contracts to operate Federal Government owned, contractor operated facilities (GOCO) are excluded from the requirements of this part.

Federal awarding agency means the Federal agency that provides an award directly to the recipient.

Federal financial assistance means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance, but does not include amounts received as reimbursement for services rendered to individuals as described in § ___.205(h) and § ___.205(i).

Federal program means:

- (1) All Federal awards to a non-Federal entity assigned a single number in the CFDA.
- (2) When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.
- (3) Notwithstanding paragraphs (1) and (2) of this definition, a cluster of programs. The types of clusters of programs are:
 - (i) Research and development (R&D);
 - (ii) Student financial aid (SFA); and
 - (iii) "Other clusters," as described in the definition of cluster of programs in this section.

GAGAS means generally accepted government auditing standards issued by the Comptroller General of the United States, which are applicable to financial audits.

Generally accepted accounting principles has the meaning specified in generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

Indian tribe means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

Internal control means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (1) Effectiveness and efficiency of operations;
- (2) Reliability of financial reporting; and
- (3) Compliance with applicable laws and regulations.

Internal control pertaining to the compliance requirements for Federal programs (Internal control over Federal programs) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

- (1) Transactions are properly recorded and accounted for to:
 - (i) Permit the preparation of reliable financial statements and Federal reports;

- (ii) Maintain accountability over assets; and
- (iii) Demonstrate compliance with laws, regulations, and other compliance requirements;
- (2) Transactions are executed in compliance with:
 - (i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and
 - (ii) Any other laws and regulations that are identified in the compliance supplement; and
- (3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Loan means a Federal loan or loan guarantee received or administered by a non-Federal entity.

Local government means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

Major program means a Federal program determined by the auditor to be a major program in accordance with § __.520 or a program identified as a major program by a Federal agency or pass-through entity in accordance with § __.215(c).

Management decision means the evaluation by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.

Non-Federal entity means a State, local government, or non-profit organization.

Non-profit organization means:

- (1) any corporation, trust, association, cooperative, or other organization that:
 - (i) Is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;
 - (ii) Is not organized primarily for profit; and
 - (iii) Uses its net proceeds to maintain, improve, or expand its operations; and
- (2) The term *non-profit organization* includes non-profit institutions of higher education and hospitals.

OMB means the Executive Office of the President, Office of Management and Budget.

Oversight agency for audit means the Federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit. When there is no direct funding, the Federal agency with the predominant indirect funding shall assume the oversight responsibilities. The duties of the oversight agency for audit are described in § __.400(b).

Pass-through entity means a non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.

Program-specific audit means an audit of one Federal program as provided for in §__.200(c) and §__.235.

Questioned cost means a cost that is questioned by the auditor because of an audit finding:

- (1) Which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds;
- (2) Where the costs, at the time of the audit, are not supported by adequate documentation; or
- (3) Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Recipient means a non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program.

Research and development (R&D) means all research activities, both basic and applied, and all development activities that are performed by a non-Federal entity. *Research* is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. The term research also includes activities involving the training of individuals in research techniques where such activities utilize the same facilities as other research and development activities and where such activities are not included in the instruction function. *Development* is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

Single audit means an audit which includes both the entity's financial statements and the Federal awards as described in §__.500.

State means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe as defined in this section.

Student Financial Aid (SFA) includes those programs of general student assistance, such as those authorized by Title IV of the Higher Education Act of 1965, as amended, (20 U.S.C. 1070 *et seq.*) which is administered by the U.S. Department of Education, and similar programs provided by other Federal agencies. It does not include programs which provide fellowships or similar Federal awards to students on a competitive basis, or for specified studies or research.

Subrecipient means a non-Federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a recipient of other Federal awards directly from a Federal awarding agency. Guidance on distinguishing between a subrecipient and a vendor is provided in §__.210.

Types of compliance requirements refers to the types of compliance requirements listed in the compliance supplement. Examples include: activities allowed or unallowed; allowable costs/cost principles; cash management; eligibility; matching, level of effort, earmarking; and, reporting.

Vendor means a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a Federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the Federal program. Additional guidance on distinguishing between a subrecipient and a vendor is provided in §____.210.

Subpart B—Audits

§____.200 Audit requirements.

(a) *Audit required.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single or program-specific audit conducted for that year in accordance with the provisions of this part. Guidance on determining Federal awards expended is provided in §____.205.

(b) *Single audit.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single audit conducted in accordance with §____.500 except when they elect to have a program-specific audit conducted in accordance with paragraph (c) of this section.

(c) *Program-specific audit election.* When an auditee expends Federal awards under only one Federal program (excluding R&D) and the Federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit conducted in accordance with §____.235. A program-specific audit may not be elected for R&D unless all of the Federal awards expended were received from the same Federal agency, or the same Federal agency and the same pass-through entity, and that Federal agency, or pass-through entity in the case of a subrecipient, approves in advance a program-specific audit.

(d) *Exemption when Federal awards expended are less than \$300,000.* Non-Federal entities that expend less than \$300,000 a year in Federal awards are exempt from Federal audit requirements for that year, except as noted in §____.215(a), but records must be available for review or audit by appropriate officials of the Federal agency, pass-through entity, and General Accounting Office (GAO).

(e) *Federally Funded Research and Development Centers (FFRDC).* Management of an auditee that owns or operates a FFRDC may elect to treat the FFRDC as a separate entity for purposes of this part.

§____.205 Basis for determining Federal awards expended.

(a) *Determining Federal awards expended.* The determination of when an award is expended should be based on when the activity related to the award occurs. Generally, the activity pertains to events that require the non-Federal entity to comply with laws, regulations, and the provisions of contracts or grant agreements, such as: expenditure/expense transactions associated with grants, cost-reimbursement contracts, cooperative agreements, and direct appropriations; the disbursement of funds passed through to subrecipients; the use of loan proceeds under loan and loan guarantee programs; the receipt of property; the receipt of surplus property; the receipt or use of program income; the distribution or consumption of food commodities; the disbursement of amounts entitling the non-Federal entity to an interest subsidy; and, the period when insurance is in force.

(b) *Loan and loan guarantees (loans).* Since the Federal Government is at risk for loans until the debt is repaid, the following guidelines shall be used to

calculate the value of Federal awards expended under loan programs, except as noted in paragraphs (c) and (d) of this section:

- (1) Value of new loans made or received during the fiscal year; plus
- (2) Balance of loans from previous years for which the Federal Government imposes continuing compliance requirements; plus
- (3) Any interest subsidy, cash, or administrative cost allowance received.

(c) *Loan and loan guarantees (loans) at institutions of higher education.* When loans are made to students of an institution of higher education but the institution does not make the loans, then only the value of loans made during the year shall be considered Federal awards expended in that year. The balance of loans for previous years is not included as Federal awards expended because the lender accounts for the prior balances.

(d) *Prior loan and loan guarantees (loans).* Loans, the proceeds of which were received and expended in prior-years, are not considered Federal awards expended under this part when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

(e) *Endowment funds.* The cumulative balance of Federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

(f) *Free rent.* Free rent received by itself is not considered a Federal award expended under this part. However, free rent received as part of an award to carry out a Federal program shall be included in determining Federal awards expended and subject to audit under this part.

(g) *Valuing non-cash assistance.* Federal non-cash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property, shall be valued at fair market value at the time of receipt or the assessed value provided by the Federal agency.

(h) *Medicare.* Medicare payments to a non-Federal entity for providing patient care services to Medicare eligible individuals are not considered Federal awards expended under this part.

(i) *Medicaid.* Medicaid payments to a subrecipient for providing patient care services to Medicaid eligible individuals are not considered Federal awards expended under this part unless a State requires the funds to be treated as Federal awards expended because reimbursement is on a cost-reimbursement basis.

(j) *Certain loans provided by the National Credit Union Administration.* For purposes of this part, loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured institutions are not considered Federal awards expended.

§ __.210 Subrecipient and vendor determinations.

(a) *General.* An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient would be subject to audit under this part. The payments received for goods or services provided as a vendor would not be considered Federal awards. The guidance in paragraphs (b) and (c) of this section should be considered in determining whether payments constitute a Federal award or a payment for goods and services.

(b) *Federal award.* Characteristics indicative of a Federal award received by a subrecipient are when the organization:

- (1) Determines who is eligible to receive what Federal financial assistance;
- (2) Has its performance measured against whether the objectives of the Federal program are met;
- (3) Has responsibility for programmatic decision making;
- (4) Has responsibility for adherence to applicable Federal program compliance requirements; and
- (5) Uses the Federal funds to carry out a program of the organization as compared to providing goods or services for a program of the pass-through entity.

(c) *Payment for goods and services.* Characteristics indicative of a payment for goods and services received by a vendor are when the organization:

- (1) Provides the goods and services within normal business operations;
- (2) Provides similar goods or services to many different purchasers;
- (3) Operates in a competitive environment;
- (4) Provides goods or services that are ancillary to the operation of the Federal program; and
- (5) Is not subject to compliance requirements of the Federal program.

(d) *Use of judgment in making determination.* There may be unusual circumstances or exceptions to the listed characteristics. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present and judgment should be used in determining whether an entity is a subrecipient or vendor.

(e) *For-profit subrecipient.* Since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits.

(f) *Compliance responsibility for vendors.* In most cases, the auditee's compliance responsibility for vendors is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. Program compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions which are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine program compliance. Also, when these vendor transactions relate to a major program, the scope of the audit shall include determining whether these transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements.

§ __.215 Relation to other audit requirements.

(a) *Audit under this part in lieu of other audits.* An audit made in accordance with this part shall be in lieu of any financial audit required under individual

Federal awards. To the extent this audit meets a Federal agency's needs, it shall rely upon and use such audits. The provisions of this part neither limit the authority of Federal agencies, including their Inspectors General, or GAO to conduct or arrange for additional audits (e.g., financial audits, performance audits, evaluations, inspections, or reviews) nor authorize any auditee to constrain Federal agencies from carrying out additional audits. Any additional audits shall be planned and performed in such a way as to build upon work performed by other auditors.

(b) *Federal agency to pay for additional audits.* A Federal agency that conducts or contracts for additional audits shall, consistent with other applicable laws and regulations, arrange for funding the full cost of such additional audits.

(c) *Request for a program to be audited as a major program.* A Federal agency may request an auditee to have a particular Federal program audited as a major program in lieu of the Federal agency conducting or arranging for the additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such request by informing the Federal agency whether the program would otherwise be audited as a major program using the risk-based audit approach described in § __.520 and, if not, the estimated incremental cost. The Federal agency shall then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon this Federal agency request, and the Federal agency agrees to pay the full incremental costs, then the auditee shall have the program audited as a major program. A pass-through entity may use the provisions of this paragraph for a subrecipient.

§ __.220 Frequency of audits.

Except for the provisions for biennial audits provided in paragraphs (a) and (b) of this section, audits required by this part shall be performed annually. Any biennial audit shall cover both years within the biennial period.

- (a) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this part biennially. This requirement must still be in effect for the biennial period under audit.
- (b) Any non-profit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this part biennially.

§ __.225 Sanctions.

No audit costs may be charged to Federal awards when audits required by this part have not been made or have been made but not in accordance with this part. In cases of continued inability or unwillingness to have an audit conducted in accordance with this part, Federal agencies and pass-through entities shall take appropriate action using sanctions such as:

- (a) Withholding a percentage of Federal awards until the audit is completed satisfactorily;
- (b) Withholding or disallowing overhead costs;
- (c) Suspending Federal awards until the audit is conducted; or
- (d) Terminating the Federal award.

§ __.230 Audit costs.

(a) *Allowable costs.* Unless prohibited by law, the cost of audits made in accordance with the provisions of this part are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB cost principles circulars, the Federal Acquisition Regulation (FAR) (48 CFR parts 30 and 31), or other applicable cost principles or regulations.

(b) *Unallowable costs.* A non-Federal entity shall not charge the following to a Federal award:

- (1) The cost of any audit under the Single Audit Act Amendments of 1996 (31 U.S.C. 7501 *et seq.*) not conducted in accordance with this part.
- (2) The cost of auditing a non-Federal entity which has Federal awards expended of less than \$300,000 per year and is thereby exempted under § __.200(d) from having an audit conducted under this part. However, this does not prohibit a pass-through entity from charging Federal awards for the cost of limited scope audits to monitor its subrecipients in accordance with § __.400(d)(3), provided the subrecipient does not have a single audit. For purposes of this part, limited scope audits only include agreed-upon procedures engagements conducted in accordance with either the AICPA's generally accepted auditing standards or attestation standards, that are paid for and arranged by a pass-through entity and address only one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and, reporting.

§ __.235 Program-specific audits.

(a) *Program-specific audit guide available.* In many cases, a program-specific audit guide will be available to provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. The auditor should contact the Office of Inspector General of the Federal agency to determine whether such a guide is available. When a current program-specific audit guide is available, the auditor shall follow GAGAS and the guide when performing a program-specific audit.

(b) *Program-specific audit guide not available.* (1) When a program-specific audit guide is not available, the auditee and auditor shall have basically the same responsibilities for the Federal program as they would have for an audit of a major program in a single audit.

- (2) The auditee shall prepare the financial statement(s) for the Federal program that includes, at a minimum, a schedule of expenditures of Federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule, a summary schedule of prior audit findings consistent with the requirements of § __.315(b), and a corrective action plan consistent with the requirements of § __.315(c).
- (3) The auditor shall:
 - (i) Perform an audit of the financial statement(s) for the Federal program in accordance with GAGAS;

- (ii) Obtain an understanding of internal control and perform tests of internal control over the Federal program consistent with the requirements of § __.500(c) for a major program;
 - (iii) Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the Federal program consistent with the requirements of § __.500(d) for a major program; and
 - (iv) Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of § __.500(e).
- (4) The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:
- (i) An opinion (or disclaimer of opinion) as to whether the financial statement(s) of the Federal program is presented fairly in all material respects in conformity with the stated accounting policies;
 - (ii) A report on internal control related to the Federal program, which shall describe the scope of testing of internal control and the results of the tests;
 - (iii) A report on compliance which includes an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on the Federal program; and
 - (iv) A schedule of findings and questioned costs for the Federal program that includes a summary of the auditor's results relative to the Federal program in a format consistent with § __.505(d)(1) and findings and questioned costs consistent with the requirements of § __.505(d)(3).

(c) *Report submission for program-specific audits.* (1) The audit shall be completed and the reporting required by paragraph (c)(2) or (c)(3) of this section submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the Federal agency that provided the funding or a different period is specified in a program-specific audit guide. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the required reporting shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period, unless a different period is specified in a program-specific audit guide.) Unless restricted by law or regulation, the auditee shall make report copies available for public inspection.

- (2) When a program-specific audit guide is available, the auditee shall submit to the Federal clearinghouse designated by OMB the data

collection form prepared in accordance with § __.320(b), as applicable to a program-specific audit, and the reporting required by the program-specific audit guide to be retained as an archival copy. Also, the auditee shall submit to the Federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

- (3) When a program-specific audit guide is not available, the reporting package for a program-specific audit shall consist of the financial statement(s) of the Federal program, a summary schedule of prior audit findings, and a corrective action plan as described in paragraph (b)(2) of this section, and the auditor's report(s) described in paragraph (b)(4) of this section. The data collection form prepared in accordance with § __.320(b), as applicable to a program-specific audit, and one copy of this reporting package shall be submitted to the Federal clearinghouse designated by OMB to be retained as an archival copy. Also, when the schedule of findings and questioned costs disclosed audit findings or the summary schedule of prior audit findings reported the status of any audit findings, the auditee shall submit one copy of the reporting package to the Federal clearinghouse on behalf of the Federal awarding agency, or directly to the pass-through entity in the case of a subrecipient. Instead of submitting the reporting package to the pass-through entity, when a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient shall provide written notification to the pass-through entity, consistent with the requirements of § __.320(e)(2). A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with this notification requirement.

(d) *Other sections of this part may apply.* Program-specific audits are subject to § __.100 through § __.215(b), § __.220 through § __.230, § __.300 through § __.305, § __.315, § __.320(f) through § __.320(j), § __.400 through § __.405, § __.510 through § __.515, and other referenced provisions of this part unless contrary to the provisions of this section, a program-specific audit guide, or program laws and regulations.

Subpart C—Auditees

§ __.300 Auditee responsibilities.

The auditee shall:

- (a) Identify, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the Federal agency, and name of the pass-through entity.
- (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.
- (c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.

- (d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with § __.310.
- (e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by § __.320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearinghouse designated by OMB and each pass-through entity providing Federal awards of the extension.
- (f) Follow up and take corrective action on audit findings, including preparation of a summary schedule of prior audit findings and a corrective action plan in accordance with § __.315(b) and § __.315(c), respectively.

§ __.305 Auditor selection.

(a) *Auditor procurement.* In procuring audit services, auditees shall follow the procurement standards prescribed by the Grants Management Common Rule (hereinafter referred to as the “A-102 Common Rule”) published March 11, 1988 and amended April 19, 1995 [insert appropriate CFR citation], Circular A-110, “Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations,” or the FAR (48 CFR part 42), as applicable (OMB Circulars are available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503). Whenever possible, auditees shall make positive efforts to utilize small businesses, minority-owned firms, and women’s business enterprises, in procuring audit services as stated in the A-102 Common Rule, OMB Circular A-110, or the FAR (48 CFR part 42), as applicable. In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.

(b) *Restriction on auditor preparing indirect cost proposals.* An auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit required by this part when the indirect costs recovered by the auditee during the prior year exceeded \$1 million. This restriction applies to the base year used in the preparation of the indirect cost proposal or cost allocation plan and any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. To minimize any disruption in existing contracts for audit services, this paragraph applies to audits of fiscal years beginning after June 30, 1998.

(c) *Use of Federal auditors.* Federal auditors may perform all or part of the work required under this part if they comply fully with the requirements of this part.

§ __.310 Financial statements.

(a) *Financial statements.* The auditee shall prepare financial statements that reflect its financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements shall be for the same organizational unit and fiscal year that is chosen to meet the requirements of this part. However, organization-wide financial

statements may also include departments, agencies, and other organizational units that have separate audits in accordance with §___.500(a) and prepare separate financial statements.

(b) *Schedule of expenditures of Federal awards.* The auditee shall also prepare a schedule of expenditures of Federal awards for the period covered by the auditee's financial statements. While not required, the auditee may choose to provide information requested by Federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a Federal program has multiple award years, the auditee may list the amount of Federal awards expended for each award year separately. At a minimum, the schedule shall:

- (1) List individual Federal programs by Federal agency. For Federal programs included in a cluster of programs, list individual Federal programs within a cluster of programs. For R&D, total Federal awards expended shall be shown either by individual award or by Federal agency and major subdivision within the Federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services.
- (2) For Federal awards received as a subrecipient, the name of the pass-through entity and identifying number assigned by the pass-through entity shall be included.
- (3) Provide total Federal awards expended for each individual Federal program and the CFDA number or other identifying number when the CFDA information is not available.
- (4) Include notes that describe the significant accounting policies used in preparing the schedule.
- (5) To the extent practical, pass-through entities should identify in the schedule the total amount provided to subrecipients from each Federal program.
- (6) Include, in either the schedule or a note to the schedule, the value of the Federal awards expended in the form of non-cash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end. While not required, it is preferable to present this information in the schedule.

§___.315 Audit findings follow-up.

(a) *General.* The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings. The auditee shall also prepare a corrective action plan for current year audit findings. The summary schedule of prior audit findings and the corrective action plan shall include the reference numbers the auditor assigns to audit findings under §___.510(c). Since the summary schedule may include audit findings from multiple years, it shall include the fiscal year in which the finding initially occurred.

(b) *Summary schedule of prior audit findings.* The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards. The summary schedule shall also include audit findings reported in the prior audit's summary schedule of prior audit findings except audit findings listed as corrected in accordance with paragraph (b)(1) of this section, or no longer valid or not warranting further action in accordance with paragraph (b)(4) of this section.

- (1) When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- (2) When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken.
- (3) When corrective action taken is significantly different from corrective action previously reported in a corrective action plan or in the Federal agency's or pass-through entity's management decision, the summary schedule shall provide an explanation.
- (4) When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position shall be described in the summary schedule. A valid reason for considering an audit finding as not warranting further action is that all of the following have occurred:
 - (i) Two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse;
 - (ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and
 - (iii) A management decision was not issued.

(c) *Corrective action plan.* At the completion of the audit, the auditee shall prepare a corrective action plan to address each audit finding included in the current year auditor's reports. The corrective action plan shall provide the name(s) of the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. If the auditee does not agree with the audit findings or believes corrective action is not required, then the corrective action plan shall include an explanation and specific reasons.

§ __.320 Report submission.

(a) *General.* The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the data collection form and reporting package shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period.) Unless restricted by law or regulation, the auditee shall make copies available for public inspection.

(b) *Data Collection.* (1) The auditee shall submit a data collection form which states whether the audit was completed in accordance with this part and provides information about the auditee, its Federal programs, and the results of the audit. The form shall be approved by OMB, available from the Federal clearinghouse designated by OMB, and include data elements similar to those presented in this paragraph. A senior level representative of the auditee (e.g., State controller, director of finance, chief executive officer, or chief financial officer) shall sign a statement to be included as part of the form certifying that: the auditee complied with the requirements of this part, the form was prepared in accordance with this part (and the instructions accompanying the form), and the information included in the form, in its entirety, are accurate and complete.

- (2) The data collection form shall include the following data elements:
- (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.
 - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
 - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.
 - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (vi) A list of the Federal awarding agencies which will receive a copy of the reporting package pursuant to § __.320(d)(2).
 - (vii) A yes or no statement as to whether the auditee qualified as a low-risk auditee under § __.530.
 - (viii) The dollar threshold used to distinguish between Type A and Type B programs as defined in § __.520(b).
 - (ix) The *Catalog of Federal Domestic Assistance* (CFDA) number for each Federal program, as applicable.
 - (x) The name of each Federal program and identification of each major program. Individual programs within a cluster of programs should be listed in the same level of detail as they are listed in the schedule of expenditures of Federal awards.
 - (xi) The amount of expenditures in the schedule of expenditures of Federal awards associated with each Federal program.
 - (xii) For each Federal program, a yes or no statement as to whether there are audit findings in each of the following types of compliance requirements and the total amount of any questioned costs:
 - (A) Activities allowed or unallowed.
 - (B) Allowable costs/cost principles.
 - (C) Cash management.
 - (D) Davis-Bacon Act.
 - (E) Eligibility.
 - (F) Equipment and real property management.
 - (G) Matching, level of effort, earmarking.
 - (H) Period of availability of Federal funds.
 - (I) Procurement and suspension and debarment.
 - (J) Program income.
 - (K) Real property acquisition and relocation assistance.

- (L) Reporting.
- (M) Subrecipient monitoring.
- (N) Special tests and provisions.
- (xiii) Auditee Name, Employer Identification Number(s), Name and Title of Certifying Official, Telephone Number, Signature, and Date.
- (xiv) Auditor Name, Name and Title of Contact Person, Auditor Address, Auditor Telephone Number, Signature, and Date.
- (xv) Whether the auditee has either a cognizant or oversight agency for audit.
- (xvi) The name of the cognizant or oversight agency for audit determined in accordance with § __.400(a) and § __.400(b), respectively.
- (3) Using the information included in the reporting package described in paragraph (c) of this section, the auditor shall complete the applicable sections of the form. The auditor shall sign a statement to be included as part of the data collection form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package described in paragraph (c) of this section, and that the content of the form is limited to the data elements prescribed by OMB.
- (c) *Reporting package.* The reporting package shall include the:
 - (1) Financial statements and schedule of expenditures of Federal awards discussed in § __.310(a) and § __.310(b), respectively;
 - (2) Summary schedule of prior audit findings discussed in § __.315(b);
 - (3) Auditor's report(s) discussed in § __.505; and
 - (4) Corrective action plan discussed in § __.315(c).
- (d) *Submission to clearinghouse.* All auditees shall submit to the Federal clearinghouse designated by OMB the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section for:
 - (1) The Federal clearinghouse to retain as an archival copy; and
 - (2) Each Federal awarding agency when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the Federal awarding agency provided directly or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the Federal awarding agency provided directly.
- (e) *Additional submission by subrecipients.* (1) In addition to the requirements discussed in paragraph (d) of this section, auditees that are also subrecipients shall submit to each pass-through entity one copy of the reporting package described in paragraph (c) of this section for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the pass-through entity provided or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the pass-through entity provided.

- (2) Instead of submitting the reporting package to a pass-through entity, when a subrecipient is not required to submit a reporting package to a pass-through entity pursuant to paragraph (e)(1) of this section, the subrecipient shall provide written notification to the pass-through entity that: an audit of the subrecipient was conducted in accordance with this part (including the period covered by the audit and the name, amount, and CFDA number of the Federal award(s) provided by the pass-through entity); the schedule of findings and questioned costs disclosed no audit findings relating to the Federal award(s) that the pass-through entity provided; and, the summary schedule of prior audit findings did not report on the status of any audit findings relating to the Federal award(s) that the pass-through entity provided. A subrecipient may submit a copy of the reporting package described in paragraph (c) of this section to a pass-through entity to comply with this notification requirement.

(f) *Requests for report copies.* In response to requests by a Federal agency or pass-through entity, auditees shall submit the appropriate copies of the reporting package described in paragraph (c) of this section and, if requested, a copy of any management letters issued by the auditor.

(g) *Report retention requirements.* Auditees shall keep one copy of the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section on file for three years from the date of submission to the Federal clearinghouse designated by OMB. Pass-through entities shall keep subrecipients' submissions on file for three years from date of receipt.

(h) *Clearinghouse responsibilities.* The Federal clearinghouse designated by OMB shall distribute the reporting packages received in accordance with paragraph (d)(2) of this section and § __.235(c)(3) to applicable Federal awarding agencies, maintain a data base of completed audits, provide appropriate information to Federal agencies, and follow up with known auditees which have not submitted the required data collection forms and reporting packages.

(i) *Clearinghouse address.* The address of the Federal clearinghouse currently designated by OMB is Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th Street, Jeffersonville, IN 47132.

(j) *Electronic filing.* Nothing in this part shall preclude electronic submissions to the Federal clearinghouse in such manner as may be approved by OMB. With OMB approval, the Federal clearinghouse may pilot test methods of electronic submissions.

Subpart D—Federal Agencies and Pass-Through Entities

§ __.400 Responsibilities.

(a) *Cognizant agency for audit responsibilities.* Recipients expending more than \$25 million a year in Federal awards shall have a cognizant agency for audit. The designated cognizant agency for audit shall be the Federal awarding agency that provides the predominant amount of direct funding to a recipient unless OMB makes a specific cognizant agency for audit assignment. To provide for continuity of cognizance, the determination of the predominant amount of direct funding shall be based upon direct Federal awards expended in the recipient's fiscal years ending in 1995, 2000, 2005, and every fifth year thereafter. For example, audit cognizance for periods ending in 1997 through 2000

will be determined based on Federal awards expended in 1995. (However, for States and local governments that expend more than \$25 million a year in Federal awards and have previously assigned cognizant agencies for audit, the requirements of this paragraph are not effective until fiscal years beginning after June 30, 2000.) Notwithstanding the manner in which audit cognizance is determined, a Federal awarding agency with cognizance for an auditee may reassign cognizance to another Federal awarding agency which provides substantial direct funding and agrees to be the cognizant agency for audit. Within 30 days after any reassignment, both the old and the new cognizant agency for audit shall notify the auditee, and, if known, the auditor of the reassignment. The cognizant agency for audit shall:

- (1) Provide technical audit advice and liaison to auditees and auditors.
- (2) Consider auditee requests for extensions to the report submission due date required by § ___.320(a). The cognizant agency for audit may grant extensions for good cause.
- (3) Obtain or conduct quality control reviews of selected audits made by non-Federal auditors, and provide the results, when appropriate, to other interested organizations.
- (4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by GAGAS or laws and regulations.
- (5) Advise the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee shall work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit shall notify the auditor, the auditee, and applicable Federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance by auditors shall be referred to appropriate State licensing agencies and professional bodies for disciplinary action.
- (6) Coordinate, to the extent practical, audits or reviews made by or for Federal agencies that are in addition to the audits made pursuant to this part, so that the additional audits or reviews build upon audits performed in accordance with this part.
- (7) Coordinate a management decision for audit findings that affect the Federal programs of more than one agency.
- (8) Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.
- (9) For biennial audits permitted under § ___.220, consider auditee requests to qualify as a low-risk auditee under § ___.530(a).

(b) *Oversight agency for audit responsibilities.* An auditee which does not have a designated cognizant agency for audit will be under the general oversight of the Federal agency determined in accordance with § ___.105. The oversight agency for audit:

- (1) Shall provide technical advice to auditees and auditors as requested.

- (2) May assume all or some of the responsibilities normally performed by a cognizant agency for audit.

(c) *Federal awarding agency responsibilities.* The Federal awarding agency shall perform the following for the Federal awards it makes:

- (1) Identify Federal awards made by informing each recipient of the CFDA title and number, award name and number, award year, and if the award is for R&D. When some of this information is not available, the Federal agency shall provide information necessary to clearly describe the Federal award.
- (2) Advise recipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements.
- (3) Ensure that audits are completed and reports are received in a timely manner and in accordance with the requirements of this part.
- (4) Provide technical advice and counsel to auditees and auditors as requested.
- (5) Issue a management decision on audit findings within six months after receipt of the audit report and ensure that the recipient takes appropriate and timely corrective action.
- (6) Assign a person responsible for providing annual updates of the compliance supplement to OMB.

(d) *Pass-through entity responsibilities.* A pass-through entity shall perform the following for the Federal awards it makes:

- (1) Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.
- (2) Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.
- (3) Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- (4) Ensure that subrecipients expending \$300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
- (5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.
- (6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.
- (7) Require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with this part.

§ __.405 Management decision.

(a) *General.* The management decision shall clearly state whether or not the audit finding is sustained, the reasons for the decision, and the expected auditee

action to repay disallowed costs, make financial adjustments, or take other action. If the auditee has not completed corrective action, a timetable for follow-up should be given. Prior to issuing the management decision, the Federal agency or pass-through entity may request additional information or documentation from the auditee, including a request for auditor assurance related to the documentation, as a way of mitigating disallowed costs. The management decision should describe any appeal process available to the auditee.

(b) *Federal agency.* As provided in § __.400(a)(7), the cognizant agency for audit shall be responsible for coordinating a management decision for audit findings that affect the programs of more than one Federal agency. As provided in § __.400(c)(5), a Federal awarding agency is responsible for issuing a management decision for findings that relate to Federal awards it makes to recipients. Alternate arrangements may be made on a case-by-case basis by agreement among the Federal agencies concerned.

(c) *Pass-through entity.* As provided in § __.400(d)(5), the pass-through entity shall be responsible for making the management decision for audit findings that relate to Federal awards it makes to subrecipients.

(d) *Time requirements.* The entity responsible for making the management decision shall do so within six months of receipt of the audit report. Corrective action should be initiated within six months after receipt of the audit report and proceed as rapidly as possible.

(e) *Reference numbers.* Management decisions shall include the reference numbers the auditor assigned to each audit finding in accordance with § __.510(c).

Subpart E—Auditors

§ __.500 Scope of audit.

(a) *General.* The audit shall be conducted in accordance with GAGAS. The audit shall cover the entire operations of the auditee; or, at the option of the auditee, such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year, provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which shall be considered to be a non-Federal entity. The financial statements and schedule of expenditures of Federal awards shall be for the same fiscal year.

(b) *Financial statements.* The auditor shall determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. The auditor shall also determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.

(c) *Internal control.* (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs.

(2) Except as provided in paragraph (c)(3) of this section, the auditor shall:

- (i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and
 - (ii) Perform testing of internal control as planned in paragraph (c)(2)(i) of this section.
- (3) When internal control over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the planning and performing of testing described in paragraph (c)(2) of this section are not required for those compliance requirements. However, the auditor shall report a reportable condition (including whether any such condition is a material weakness) in accordance with § __.510, assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.

(d) *Compliance.* (1) In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs.

- (2) The principal compliance requirements applicable to most Federal programs and the compliance requirements of the largest Federal programs are included in the compliance supplement.
- (3) For the compliance requirements related to Federal programs contained in the compliance supplement, an audit of these compliance requirements will meet the requirements of this part. Where there have been changes to the compliance requirements and the changes are not reflected in the compliance supplement, the auditor shall determine the current compliance requirements and modify the audit procedures accordingly. For those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.
- (4) The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.

(e) *Audit follow-up.* The auditor shall follow-up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee in accordance with § __.315(b), and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor shall perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year.

(f) *Data Collection Form.* As required in § __.320(b)(3), the auditor shall complete and sign specified sections of the data collection form.

§ __.505 Audit reporting.

The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:

- (a) An opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and an opinion (or disclaimer of opinion) as to whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- (b) A report on internal control related to the financial statements and major programs. This report shall describe the scope of testing of internal control and the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (c) A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report shall also include an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on each major program, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (d) A schedule of findings and questioned costs which shall include the following three components:
 - (1) A summary of the auditor's results which shall include:
 - (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses;
 - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee;
 - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses;
 - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (vi) A statement as to whether the audit disclosed any audit findings which the auditor is required to report under § __.510(a);
 - (vii) An identification of major programs;

- (viii) The dollar threshold used to distinguish between Type A and Type B programs, as described in §___.520(b); and
 - (ix) A statement as to whether the auditee qualified as a low-risk auditee under §___.530.
- (2) Findings relating to the financial statements which are required to be reported in accordance with GAGAS.
 - (3) Findings and questioned costs for Federal awards which shall include audit findings as defined in §___.510(a).
 - (i) Audit findings (e.g., internal control findings, compliance findings, questioned costs, or fraud) which relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by Federal agency or pass-through entity.
 - (ii) Audit findings which relate to both the financial statements and Federal awards, as reported under paragraphs (d)(2) and (d)(3) of this section, respectively, should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form with a reference to a detailed reporting in the other section of the schedule.

§___.510 Audit findings.

(a) *Audit findings reported.* The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

- (1) Reportable conditions in internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement. The auditor shall identify reportable conditions which are individually or cumulatively material weaknesses.
- (2) Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement.
- (3) Known questioned costs which are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor shall also report known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. In reporting questioned costs, the auditor shall include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- (4) Known questioned costs which are greater than \$10,000 for a Federal program which is not audited as a major program. Except for audit follow-up, the auditor is not required under this part to perform audit procedures for such a Federal program; therefore, the auditor will normally not find questioned costs for a program which is not audited as a major program. However, if the auditor does become aware of questioned costs for a Federal program which is not audited as a major program (e.g., as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor shall report this as an audit finding.
- (5) The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for Federal awards.
- (6) Known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.
- (7) Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with § __.315(b) materially misrepresents the status of any prior audit finding.

(b) *Audit finding detail.* Audit findings shall be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for Federal agencies and pass-through entities to arrive at a management decision. The following specific information shall be included, as applicable, in audit findings:

- (1) Federal program and specific Federal award identification including the CFDA title and number, Federal award number and year, name of Federal agency, and name of the applicable pass-through entity. When information, such as the CFDA title and number or Federal award number, is not available, the auditor shall provide the best information available to describe the Federal award.
- (2) The criteria or specific requirement upon which the audit finding is based, including statutory, regulatory, or other citation.
- (3) The condition found, including facts that support the deficiency identified in the audit finding.
- (4) Identification of questioned costs and how they were computed.
- (5) Information to provide proper perspective for judging the prevalence and consequences of the audit findings, such as whether the audit findings represent an isolated instance or a systemic problem. Where appropriate, instances identified shall be related to the universe and the number of cases examined and be quantified in terms of dollar value.
- (6) The possible asserted effect to provide sufficient information to the auditee and Federal agency, or pass-through entity in the case of a subrecipient, to permit them to determine the cause and effect to facilitate prompt and proper corrective action.

- (7) Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- (8) Views of responsible officials of the auditee when there is disagreement with the audit findings, to the extent practical.

(c) *Reference numbers.* Each audit finding in the schedule of findings and questioned costs shall include a reference number to allow for easy referencing of the audit findings during follow-up.

§ __.515 Audit working papers.

(a) *Retention of working papers.* The auditor shall retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report(s) to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the Federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor shall contact the parties contesting the audit finding for guidance prior to destruction of the working papers and reports.

(b) *Access to working papers.* Audit working papers shall be made available upon request to the cognizant or oversight agency for audit or its designee, a Federal agency providing direct or indirect funding, or GAO at the completion of the audit, as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this part. Access to working papers includes the right of Federal agencies to obtain copies of working papers, as is reasonable and necessary.

§ __.520 Major program determination.

(a) *General.* The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of: Current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program. The process in paragraphs (b) through (i) of this section shall be followed.

(b) *Step 1.* (1) The auditor shall identify the larger Federal programs, which shall be labeled Type A programs. Type A programs are defined as Federal programs with Federal awards expended during the audit period exceeding the larger of:

- (i) \$300,000 or three percent (.03) of total Federal awards expended in the case of an auditee for which total Federal awards expended equal or exceed \$300,000 but are less than or equal to \$100 million.
 - (ii) \$3 million or three-tenths of one percent (.003) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$100 million but are less than or equal to \$10 billion.
 - (iii) \$30 million or 15 hundredths of one percent (.0015) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$10 billion.
- (2) Federal programs not labeled Type A under paragraph (b)(1) of this section shall be labeled Type B programs.
 - (3) The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as Type A programs. When

a Federal program providing loans significantly affects the number or size of Type A programs, the auditor shall consider this Federal program as a Type A program and exclude its values in determining other Type A programs.

- (4) For biennial audits permitted under § __.220, the determination of Type A and Type B programs shall be based upon the Federal awards expended during the two-year period.

(c) *Step 2.* (1) The auditor shall identify Type A programs which are low-risk. For a Type A program to be considered low-risk, it shall have been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and, in the most recent audit period, it shall have had no audit findings under § __.510(a). However, the auditor may use judgment and consider that audit findings from questioned costs under § __.510(a)(3) and § __.510(a)(4), fraud under § __.510(a)(6), and audit follow-up for the summary schedule of prior audit findings under § __.510(a)(7) do not preclude the Type A program from being low-risk. The auditor shall consider: the criteria in § __.525(c), § __.525(d)(1), § __.525(d)(2), and § __.525(d)(3); the results of audit follow-up; whether any changes in personnel or systems affecting a Type A program have significantly increased risk; and apply professional judgment in determining whether a Type A program is low-risk.

- (2) Notwithstanding paragraph (c)(1) of this section, OMB may approve a Federal awarding agency's request that a Type A program at certain recipients may not be considered low-risk. For example, it may be necessary for a large Type A program to be audited as major each year at particular recipients to allow the Federal agency to comply with the Government Management Reform Act of 1994 (31 U.S.C. 3515). The Federal agency shall notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year to be audited of OMB's approval.

(d) *Step 3.* (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in § __.525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in § __.525(b)(1), § __.525(b)(2), and § __.525(c)(1), a single criteria in § __.525 would seldom cause a Type B program to be considered high-risk.

- (2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:
- (i) \$100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to \$100 million in total Federal awards expended.
 - (ii) \$300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than \$100 million in total Federal awards expended.

(e) *Step 4.* At a minimum, the auditor shall audit all of the following as major programs:

- (1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).
- (2) (i) High-risk Type B programs as identified under either of the following two options:
 - (A) *Option 1.* At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph (e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.
 - (B) *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.
- (ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B) of this section, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.
- (3) Such additional programs as may be necessary to comply with the percentage of coverage rule discussed in paragraph (f) of this section. This paragraph (e)(3) may require the auditor to audit more programs as major than the number of Type A programs.

(f) *Percentage of coverage rule.* The auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the auditee meets the criteria in § __.530 for a low-risk auditee, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 25 percent of total Federal awards expended.

(g) *Documentation of risk.* The auditor shall document in the working papers the risk analysis process used in determining major programs.

(h) *Auditor's judgment.* When the major program determination was performed and documented in accordance with this part, the auditor's judgment in applying the risk-based approach to determine major programs shall be presumed correct. Challenges by Federal agencies and pass-through entities shall only be for clearly improper use of the guidance in this part. However, Federal agencies and pass-through entities may provide auditors guidance about the risk of a particular Federal program and the auditor shall consider this guidance in determining major programs in audits not yet completed.

(i) *Deviation from use of risk criteria.* For first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs as necessary to meet the percentage of coverage rule discussed in paragraph (f) of this section. Under this option, the auditor would not be required to perform the procedures discussed in paragraphs (c), (d), and (e) of this section.

- (1) A first-year audit is the first year the entity is audited under this part or the first year of a change of auditors.
- (2) To ensure that a frequent change of auditors would not preclude audit of high-risk Type B programs, this election for first-year audits may not be used by an auditee more than once in every three years.

§ __.525 Criteria for Federal program risk.

(a) *General.* The auditor's determination should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program. The auditor shall use auditor judgment and consider criteria, such as described in paragraphs (b), (c), and (d) of this section, to identify risk in Federal programs. Also, as part of the risk analysis, the auditor may wish to discuss a particular Federal program with auditee management and the Federal agency or pass-through entity.

(b) *Current and prior audit experience.* (1) Weaknesses in internal control over Federal programs would indicate higher risk. Consideration should be given to the control environment over Federal programs and such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements and the competence and experience of personnel who administer the Federal programs.

- (i) A Federal program administered under multiple internal control structures may have higher risk. When assessing risk in a large single audit, the auditor shall consider whether weaknesses are isolated in a single operating unit (e.g., one college campus) or pervasive throughout the entity.
 - (ii) When significant parts of a Federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.
 - (iii) The extent to which computer processing is used to administer Federal programs, as well as the complexity of that processing, should be considered by the auditor in assessing risk. New and recently modified computer systems may also indicate risk.
- (2) Prior audit findings would indicate higher risk, particularly when the situations identified in the audit findings could have a significant impact on a Federal program or have not been corrected.
- (3) Federal programs not recently audited as major programs may be of higher risk than Federal programs recently audited as major programs without audit findings.

(c) *Oversight exercised by Federal agencies and pass-through entities.* (1) Oversight exercised by Federal agencies or pass-through entities could indicate risk. For example, recent monitoring or other reviews performed by an oversight entity which disclosed no significant problems would indicate lower risk. However, monitoring which disclosed significant problems would indicate higher risk.

- (2) Federal agencies, with the concurrence of OMB, may identify Federal programs which are higher risk. OMB plans to provide this identification in the compliance supplement.

(d) *Inherent risk of the Federal program.* (1) The nature of a Federal program may indicate risk. Consideration should be given to the complexity of the program and the extent to which the Federal program contracts for goods and services. For example, Federal programs that disburse funds through third party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high-risk for time and effort reporting, but otherwise be at low-risk.

- (2) The phase of a Federal program in its life cycle at the Federal agency may indicate risk. For example, a new Federal program with new or

interim regulations may have higher risk than an established program with time-tested regulations. Also, significant changes in Federal programs, laws, regulations, or the provisions of contracts or grant agreements may increase risk.

- (3) The phase of a Federal program in its life cycle at the auditee may indicate risk. For example, during the first and last years that an auditee participates in a Federal program, the risk may be higher due to start-up or closeout of program activities and staff.
- (4) Type B programs with larger Federal awards expended would be of higher risk than programs with substantially smaller Federal awards expended.

§ __.530 Criteria for a low-risk auditee.

An auditee which meets all of the following conditions for each of the preceding two years (or, in the case of biennial audits, preceding two audit periods) shall qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with § __.520:

- (a) Single audits were performed on an annual basis in accordance with the provisions of this part. A non-Federal entity that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- (b) The auditor's opinions on the financial statements and the schedule of expenditures of Federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of Federal awards and provide a waiver.
- (c) There were no deficiencies in internal control which were identified as material weaknesses under the requirements of GAGAS. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of Federal awards and provide a waiver.
- (d) None of the Federal programs had audit findings from any of the following in either of the preceding two years (or, in the case of biennial audits, preceding two audit periods) in which they were classified as Type A programs:
 - (1) Internal control deficiencies which were identified as material weaknesses;
 - (2) Noncompliance with the provisions of laws, regulations, contracts, or grant agreements which have a material effect on the Type A program; or
 - (3) Known or likely questioned costs that exceed five percent of the total Federal awards expended for a Type A program during the year.

Appendix A to Part __—Data Collection Form (Form SF-SAC)

[Insert SF-SAC after finalized]

Appendix B to Part __—Circular A-133 Compliance Supplement

Note: Provisional OMB Circular A-133 Compliance Supplement is available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503.

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APPENDIX C

Illustrative Schedules of Expenditures of Federal Awards

Example Entity
Schedule of Expenditures of Federal Awards¹
For the Year Ended June 30, 20X1²

<i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i>	<i>Federal CFDA Number³</i>	<i>Pass-Through Entity Identifying Number⁴</i>	<i>Federal Expenditures⁵</i>
U.S. Department of Agriculture:			
Summer Food Service Program for Children—Commodities	10.559		\$ 46,000
<i>Total U.S. Department of Agriculture</i>			\$ 46,000
U.S. Department of Housing and Urban Development:			
Community Development Block Grant—Entitlement Grants (note 2)	14.218		\$1,235,632
Section 8 Rental Voucher Program	14.855		800,534
<i>Total U.S. Department of Housing and Urban Development</i>			\$2,036,166
U.S. Department of Education:*			
Impact Aid	84.041		\$ 372,555
Bilingual Education	84.288		28,655
Subtotal Direct Programs			\$ 401,210
Pass-Through Program From:			
State Department of Education— Title I Grants to Local Educational Agencies	84.010	23-8345-7612	\$1,239,398
<i>Total U.S. Department of Education</i>			\$1,640,608
<i>Total Expenditures of Federal Awards</i>			<u>\$3,722,774</u>

The accompanying notes are an integral part of this schedule.

¹ To meet state or other requirements, auditees may decide to include certain nonfederal awards (for example, state awards) in this schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

² Additional guidance on the schedule is provided in chapter 5 which includes a discussion of the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, noncash awards, and endowment funds. Chapter 5 also includes a discussion of the auditor's responsibility for reporting on the schedule.

³ When the CFDA number is not available, the auditee should indicate that the CFDA number is not available and include in the schedule the program's name and, if available, other identifying number.

⁴ When awards are received as a subrecipient, the identifying number assigned by the pass-through entity should be included in the schedule.

⁵ Circular A-133 requires that the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end be included in either the schedule or a note to the schedule. Although it is not required, Circular A-133 states that it is preferable to present this information in the schedule (versus the notes to the schedule). If the auditee presents noncash assistance in the notes to the schedule, the auditor should be aware that such amounts must still be included in part III of the data collection form.

* Institutions of higher education also participate in certain loan and loan guarantee programs (for example the Federal Family Education Loan Program [FFELP] and the Direct Loan Program) that are not included in this illustration. Circular A-133 requires that when loans are made to students but the institution of higher education does not make the loans, the value of the loans made during the year are considered federal awards expended. Those loans and loan guarantees should be reported either on the face of the schedule or disclosed in the notes to the schedule (see chapter 5 for further discussion of noncash awards, including loans and loan guarantees).

Example Entity
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 20X1

Note 1. Basis of Presentation⁶

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity and is presented on the [*identify basis of accounting*]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [*general-purpose or basic*] financial statements.

Note 2. Subrecipients⁷

Of the federal expenditures presented in the schedule, Example Entity provided federal awards to subrecipients as follows:

<i>Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Provided to Subrecipients</i>
Community Development Block Grant—Entitlement Grants	14.218	\$423,965

⁶ This note is included to meet the Circular A-133 requirement that the schedule include notes that describe the significant accounting policies used in preparing the schedule.

⁷ Circular A-133 requires the schedule of expenditures of federal awards to include, to the extent practical, an identification of the total amount provided to subrecipients from each federal program. Although this example includes the required subrecipient information in the notes to the schedule, the information may be included on the face of the schedule as a separate column or section, if that is preferred by the auditee.

Example Entity University
Schedule of Expenditures of Federal Awards⁸
For the Year Ended June 30, 20X1⁹

<i>Federal Grantor / Pass-Through Grantor / Program or Cluster Title</i>	<i>Federal CFDA¹⁰ Number</i>	<i>Pass-Through Entity Identifying Number¹¹</i>	<i>Federal Expenditures¹²</i>
<i>Student Financial Aid—Cluster:</i>			
U.S. Department of Education:			
Federal Pell Grant Program	84.063		\$ 8,764,943
Federal Supplemental Educational Opportunity Grant	84.007		974,873
Federal Work-Study Program	84.033		575,417
Federal Perkins Loan Program (note 2)	84.038		<u>1,548,343</u>
<i>Total U.S. Department of Education</i>			<u>\$11,863,576</u>
U.S. Department of Health and Human Services:			
Nursing Student Loans (note 2)	93.364		\$ 823,582
<i>Total U.S. Department of Health and Human Services</i>			<u>\$ 823,582</u>
<i>Total Student Financial Aid</i>			<u>\$12,687,158</u>
<i>Research and Development—Cluster:¹³</i>			
U.S. Department of Defense:			
Department of Army	N.A.		\$ 87,403
Office of Naval Research	N.A.		<u>73,107</u>
Subtotal Direct Programs			<u>\$ 160,510</u>
Pass-Through Programs From:			
XYZ Labs—Effects of Ice on Radar Images	N.A.	4532	<u>\$ 11,987</u>
<i>Total U.S. Department of Defense</i>			<u>\$ 172,497</u>
National Science Foundation:			
National Science Foundation (note 3)	N.A.		\$ 432,111
Pass-Through Programs From:			
ABC University—Atmospheric Effects of Volcano Eruptions	N.A.	Abc97-8	<u>\$ 25,987</u>
<i>Total National Science Foundation</i>			<u>\$ 458,098</u>
U.S. Department of Health and Human Services:			
National Institutes of Health	N.A.		\$ 675,321
Administration on Aging (note 3)	N.A.		<u>234,987</u>
Subtotal Direct Programs			<u>\$ 910,308</u>

⁸ See footnote 1.⁹ See footnote 2.¹⁰ See footnote 3.¹¹ See footnote 4.¹² See footnote 5.¹³ For R&D, Circular A-133 requires that total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. This example illustrates the federal agency and major subdivision option.

<i>Federal Grantor / Pass-Through Grantor / Program or Cluster Title</i>	<i>Federal CFDA Number¹⁰</i>	<i>Pass-Through Entity Identifying Number¹¹</i>	<i>Federal Expenditures¹²</i>
Pass-Through Programs From:			
ABC Hospital—Heart Research	N.A.	5489-5	\$ 432,765
State Health Department—Food Safety Research	N.A.	SG673-45	123,987
Subtotal Pass-Through Programs			\$ 556,752
<i>Total U.S. Department of Health and Human Services</i>			\$ 1,467,060
<i>Total Research and Development</i>			\$ 2,097,655
Other Programs:			
U.S. Department of Energy:			
Educational Exchange—University Lectures and Research	82.002		\$ 17,823
<i>Total U.S. Department of Energy</i>			\$ 17,823
U.S. Department of Education:			
TRIO Talent Search	84.044		\$ 308,465
Safe and Drug-Free Schools and Communities	84.184		59,723
Subtotal Direct Programs			\$ 368,188
Pass-Through Programs From:			
State Department of Education—Vocational Education Basic Grant	84.048	874-90-5473	\$ 3,115
State Department of Education— Tech-Prep Education	84.243	25-8594-2167	176,885
Subtotal Pass-Through Programs			\$ 180,000
<i>Total U.S. Department of Education</i>			\$ 548,188
<i>Total Other Programs</i>			\$ 566,011
<i>Total Expenditures of Federal Awards</i>			<u>\$15,350,824</u>
N.A. = Not Available			

The accompanying notes are an integral part of this schedule.

Example Entity University
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 20X1

Note 1. Basis of Presentation¹⁴

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity University and is presented on the [identify basis of accounting]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [general-purpose or basic] financial statements.

Note 2. Loans Outstanding¹⁵

Example Entity University had the following loan balances outstanding at June 30, 20X1. These loan balances outstanding are also included in the federal expenditures presented in the schedule.

<i>Cluster / Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Outstanding</i>
Federal Perkins Loan Program	84.038	\$1,268,236
Nursing Student Loans	93.364	\$ 763,127

Note 3. Subrecipients¹⁶

Of the federal expenditures presented in the schedule, Example Entity University provided federal awards to subrecipients as follows:

<i>Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Provided to Subrecipients</i>
National Science Foundation	N.A.	\$236,403
Administration on Aging	N.A.	\$138,095

¹⁴ See footnote 6.

¹⁵ This note is intended to meet the Circular A-133 requirement that loans or loan guarantees outstanding at year end be included in the schedule.

¹⁶ See footnote 7.

APPENDIX D

Illustrative Auditor's Reports

D.1. This appendix contains examples of the reports issued under GAAS, *Government Auditing Standards*, and Circular A-133 in various circumstances for a single audit. Also included are examples of the reports issued for a program-specific audit.

D.2. As discussed in chapter 10, reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a single audit (the basic elements of each of the recommended reports are discussed in chapter 10):

- An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards
- A report on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*
- A report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133

D.3. Furthermore, as discussed in chapter 11, this SOP recommends that the following reports be issued for a program-specific audit (see paragraph 11.10 for a discussion of the possible issuance of a separate report to meet the reporting requirements of *Government Auditing Standards*): (a) an opinion on the financial statement(s) of the federal program and (b) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under Circular A-133.

D.4. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee's situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

D.5. The following example auditor's reports illustrate the types of reports to be issued in selected situations. Chapters 10 and 11 of this SOP include discussions of certain of the situations and the resulting reports contained herein. For additional guidance the auditor should refer to SAS No. 58, *Reports on Audited Financial Statements*.

D.6. The following is a list of the example reports in this appendix:

Example No.	Title
1	Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity
1a	Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization
2	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])
2a	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (<i>Reportable Instances of Noncompliance and Reportable Conditions Identified</i>)
3	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses</i> [No Reportable Conditions Identified])
3a	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance and Reportable Conditions Identified</i>)
4	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified</i>)
5	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses Identified</i>)
6	Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133
6a	Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses</i> [No Reportable Conditions Identified])

NOTE

The Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* (Guide) contains guidance for planning, performing, evaluating the results of, and reporting on the audits of financial statements issued by state and local governments that have or are required to apply the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. The Guide is effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply the provisions of GASB Statement Nos. 34 or 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. Earlier application of the Guide is encouraged if a government issues financial statements that apply GASB Statement Nos. 34 or 35 after the Guide is issued. The Guide specifies that auditor reporting on the audits of such governmental financial statements should be based on opinion units. Auditors who are auditing the financial statements of state and local governments using the provisions of the Guide should refer to Example 14.A1 in the Guide for an illustration of unqualified opinions on a government's basic financial statements.

Example 1

Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity¹

Independent Auditor's Report

[Addressee]

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,² issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in

¹ Auditors may also refer to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* for additional guidance on reporting on the general-purpose financial statements of a government.

² The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of the City of Example, Any State, as of June 30, 20X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.³

The accompanying schedule of expenditures of federal awards⁴ is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the general-purpose financial statements. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.⁵

[Signature]

[Date]

³ The following paragraph should be deleted if the schedule of expenditures of federal awards is not presented with the general-purpose financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. See footnotes 34 and 40 for additional guidance.

⁴ If the auditor is reporting on additional supplementary information (for example, combining and individual fund and account group financial statements and schedules), this paragraph should be modified to describe the additional supplementary information. The example reports in appendix A of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), provide useful guidance.

⁵ When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09-.11, .13, and .14).

Example 1a

Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization⁶

Independent Auditor's Report

[Addressee]

We have audited the accompanying statement of financial position of Example NFP as of June 30, 20X1, and the related statements of activities and cash flows⁷ for the year then ended. These financial statements are the responsibility of Example NFP's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,⁸ issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Example NFP as of June 30, 20X1, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example NFP's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.⁹

The accompanying schedule of expenditures of federal awards¹⁰ is presented for purposes of additional analysis as required by U.S. Office of Management and

⁶ Auditors may also refer to the AICPA Audit and Accounting Guide *Not-For-Profit Organizations* for additional guidance on reporting on the financial statements of a not-for-profit organization.

⁷ If the not-for-profit organization is a voluntary health and welfare organization, this phrase should be modified to state "and the related statements of activities, functional expenses and cash flows."

⁸ See footnote 2.

⁹ See footnote 3.

¹⁰ If the auditor is reporting on additional supplementary information (for example, a comparison of actual and budgeted expenses), this paragraph should be modified to describe the additional supplementary information. SAS No. 29 provides useful guidance.

Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.¹¹

[Signature]

[Date]

¹¹ See footnote 5.

Example 2

**Report on Compliance and on Internal Control Over
Financial Reporting¹² Based on an Audit of Financial
Statements Performed in Accordance With Government
Auditing Standards (No Reportable Instances of
Noncompliance and No Material Weaknesses [No
Reportable Conditions Identified])¹³**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1.¹⁴ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards*,¹⁵ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.^{16, 17}

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures

¹² See paragraph 4.12 for a description of internal control over financial reporting.

¹³ The auditor should use the portions of examples 2 and 2a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 2a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 2a.

¹⁴ Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

¹⁵ See footnote 2.

¹⁶ See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

¹⁷ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "However, we noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 20X1." This reference to management is intended to be consistent with paragraph 5.20 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.¹⁸

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.^{19, 20}

[Signature]

[Date]

¹⁸ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "However, we noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 20X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

¹⁹ If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and [*specify legislative or regulatory body*] and is not intended to be and should not be used by anyone other than these specified parties."

²⁰ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

Example 2a

**Report on Compliance and on Internal Control Over
Financial Reporting²¹ Based on an Audit of Financial
Statements Performed in Accordance With Government
Auditing Standards (Reportable Instances of
Noncompliance and Reportable Conditions Identified)²²**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1.²³ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,²⁴ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*²⁵ and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 20X1-2 and 20X1-5].²⁶

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Example Entity's ability

²¹ See footnote 12.

²² See footnote 13.

²³ See footnote 14.

²⁴ See footnote 2.

²⁵ See footnote 16.

²⁶ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "We also noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 20X1." This reference to management is intended to be consistent with chapter 5, paragraph 5.20 of *Government Auditing Standards*, which indicates that communications to "top" management should be referred to.

to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 20X1-1, 20X1-4, and 20X1-8]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{27, 28}

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.^{29, 30}

[Signature]

[Date]

²⁷ If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be replaced with language such as the following: "However, of the reportable conditions described above, we consider items *[list the reference numbers of the related findings, for example, 20X1-1 and 20X1-8]* to be material weaknesses."

²⁸ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "We also noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 20X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

²⁹ If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and *[specify legislative or regulatory body]* and is not intended to be and should not be used by anyone other than these specified parties." All references to the schedule of findings and questioned costs should also be removed, and instead, a description of the findings should be included in the report.

³⁰ See footnote 20.

Example 3

**Report on Compliance With Requirements Applicable to
Each Major Program and on Internal Control Over
Compliance in Accordance With OMB Circular A-133
(Unqualified Opinion on Compliance and No Material
Weaknesses [No Reportable Conditions Identified])³¹**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,³² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 20X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 20X1-3 and 20X1-6].³³

³¹ The auditor should use the portions of examples 3 and 3a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 3a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 3a.

³² See footnote 2.

³³ When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.³⁴

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.³⁵

[Signature]

[Date]

³⁴ As noted in notes 3 and 9, there may be instances in which it would be appropriate to report on the schedule of expenditures of federal awards in this report (that is, a separate single audit package is issued). In such a circumstance, a new section should be added immediately following this paragraph as follows:

Schedule of Expenditures of Federal Awards

We have audited the [*general-purpose or basic*] financial statements of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1. Our audit was performed for the purpose of forming an opinion on the [*general-purpose or basic*] financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the [*general-purpose or basic*] financial statements. Such information has been subjected to the auditing procedures applied in the audit of the [*general-purpose or basic*] financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the [*general-purpose or basic*] financial statements taken as a whole.

Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Auditors should also refer to notes 5 and 11 for additional guidance.

³⁵ See footnote 20.

Example 3a

**Report on Compliance With Requirements
Applicable to Each Major Program and on
Internal Control Over Compliance in Accordance
With OMB Circular A-133 (*Qualified Opinion
on Compliance and Reportable Conditions Identified*)³⁶**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,³⁷ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether non-compliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in item [list the reference numbers of the related findings, for example, 20X1-10] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the type(s) of compliance requirement] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Example Entity complied, in all material respects, with the requirements

³⁶ See footnote 31.

³⁷ See footnote 2.

referred to above that are applicable to each of its major federal programs for the year ended June 30, 20X1.³⁸

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 20X1-7, 20X1-8, and 20X1-9]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{39, 40}

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.⁴¹

[Signature]

[Date]

³⁸ When other instances of noncompliance are identified in the schedule of findings and questioned costs as required by Circular A-133, the following sentence should be added: "The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 20X1-3 and 20X1-6]*."

³⁹ See footnote 27.

⁴⁰ See footnote 34.

⁴¹ See footnote 20.

Example 4

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified)

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,⁴² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the compliance of Example Entity with [identify the major federal program] regarding [identify the type(s) of compliance requirement], nor were we able to satisfy ourselves as to Example Entity's compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding Example Entity's compliance with the requirements of [identify the major federal program] regarding [identify the type(s) of compliance requirement],

⁴² See footnote 2.

Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 20X1.⁴³

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as *items* [list the reference numbers of the related findings, for example, 20X1-7, 20X1-8, and 20X1-9].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{44, 45}

This report is intended solely for the information and use of the audit committee, management, [specify legislative or regulatory body], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.⁴⁶

[Signature]

[Date]

⁴³ See footnote 38.

⁴⁴ See footnote 27.

⁴⁵ See footnote 34.

⁴⁶ See footnote 20.

Example 5

**Report on Compliance With Requirements Applicable to
Each Major Program and on Internal Control Over
Compliance in Accordance With OMB Circular A-133
(Adverse Opinion on Compliance for One Major Program,
Unqualified Opinion on Compliance for Other Major
Programs, and Material Weaknesses Identified)**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,⁴⁷ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in items [list the reference numbers of the related findings, for example, 20X1-10, 20X1-11, and 20X1-12] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the types of compliance requirements] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, Example Entity did not comply in all material respects,

⁴⁷ See footnote 2.

with the requirements referred to above that are applicable to [*identify the major federal program*]. Also, in our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 20X1.⁴⁸

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 20X1-7, 20X1-8, and 20X1-9*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items [*list the reference numbers of the related findings, for example 20X1-8 and 20X1-9*] to be material weaknesses.⁴⁹

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.⁵⁰

[Signature]

[Date]

⁴⁸ See footnote 38.

⁴⁹ See footnote 34.

⁵⁰ See footnote 20.

Example 6

Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133

Independent Auditor's Report

We have audited the accompanying schedule of expenditures of federal awards for the [*identify the federal program*] of Example Entity for the year ended June 30, 20X1. This financial statement is the responsibility of Example Entity's management. Our responsibility is to express an opinion on the financial statement of the program based on our audit.⁵¹

We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,⁵² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of expenditures of federal awards referred to above⁵³ presents fairly, in all material respects, the expenditures of federal awards under the [*identify the federal program*] in conformity with accounting principles generally accepted in the United States of America.^{54, 55}

[Signature]

[Date]

⁵¹ In many cases, the financial statements of the program will consist only of the schedule of expenditures of federal awards (and notes to the schedule), which is the minimum financial statement presentation required by section 235 of Circular A-133. If the auditee issues financial statements that consist of more than the schedule, this paragraph should be modified to describe the financial statements. Also refer to paragraph 11.10 for a discussion of the possible necessity to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

⁵² See footnote 2.

⁵³ If the auditee issues financial statements that consist of more than the schedule, this sentence should be modified to identify the results displayed in the financial presentation.

⁵⁴ The auditor should follow the guidance in SAS No. 62, *Special Reports* when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than GAAP.

⁵⁵ If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 11.10), an additional paragraph should be added as follows: "In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants."

Example 6a

**Report on Compliance With Requirements Applicable
to the Federal Program and on Internal Control Over
Compliance in Accordance With the Program-Specific Audit
Option Under OMB Circular A-133⁵⁶ (Unqualified Opinion
on Compliance and No Material Weaknesses [No
Reportable Conditions Identified])⁵⁷**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to [identify the federal program] for the year ended June 30, 20X1. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,⁵⁸ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on [identify the federal program] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to its [identify the federal program] for the year ended June 30, 20X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and

⁵⁶ This is an example of a report on a program-specific audit under Circular A-133 when no federal audit guide applicable to the program being audited is available. When a federal audit guide applicable to the program is available, Circular A-133 requires that the auditor follow the reporting requirements of that federal audit guide (see paragraph 11.4 for a discussion of the auditor's responsibility when a program-specific audit guide is not current).

⁵⁷ If issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report to be consistent with the wording used in examples 3a or 5, accordingly. If reporting reportable conditions, including material weaknesses, the auditor should modify the internal control section of this report to be consistent with the wording used in example 3a.

⁵⁸ See footnote 2.

which are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 20X1-1 and 20X1-2]*.⁵⁹

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on its *[identify the federal program]* in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and the federal awarding agency and pass-through entity and is not intended to be and should not be used by anyone other than these specified parties.⁶⁰

[Signature]

[Date]

⁵⁹ See footnote 33.

⁶⁰ See footnote 20.

APPENDIX E**Illustrative Schedule of Findings and Questioned Costs**

Example Entity
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 20X1

Section I—Summary of Auditor's Results

Financial Statements

Type of auditor's report issued [*unqualified, qualified, adverse, or disclaimer*]:

Internal control over financial reporting:

- Material weakness(es) identified? _____ yes _____ no
- Reportable condition(s) identified that are not considered to be material weaknesses? _____ yes _____ none reported

Noncompliance material to financial statements noted? _____ yes _____ no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? _____ yes _____ no
- Reportable condition(s) identified that are not considered to be material weakness(es)? _____ yes _____ none reported

Type of auditor's report issued on compliance for major programs [*unqualified, qualified, adverse, or disclaimer*]:¹

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? _____ yes _____ no

Identification of major programs:²

CFDA Number(s)³

Name of Federal Program or Cluster⁴

¹ If the audit report for one or more major programs is other than unqualified, indicate the type of report issued for each program. For example, if the audit report on major program compliance for an auditee having five major programs includes an unqualified opinion for three of the programs, a qualified opinion for one program, and a disclaimer of opinion for one program, the response to this question could be as follows: "Unqualified for all major programs except for [name of program], which was qualified and [name of program], which was a disclaimer."

² Major programs should generally be identified in the same order as reported on the schedule of expenditures of federal awards.

³ When the CFDA number is not available, include other identifying number, if applicable.

⁴ The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards. For clusters, auditors are only required to list the name of the cluster and not each individual program within the cluster.

Dollar threshold used to distinguish
between type A and type B programs: \$ _____
Auditee qualified as low-risk auditee? _____ yes _____ no

Section II—Financial Statement Findings

[This section identifies the reportable conditions, material weaknesses, and instances of noncompliance related to the financial statements that are required to be reported in accordance with paragraphs 5.18 through 5.20 of Government Auditing Standards. Auditors should refer to those paragraphs, as well as the reports content section of chapter 7 of Government Auditing Standards, for additional guidance on preparing this section of the schedule.]

Identify each finding with a reference number.⁵ If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that effects an entity as a whole, including its federal awards, would generally be reported in detail in this section. Section III would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:

- *Criteria or specific requirement*
- *Condition*
- *Context⁶*
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response⁷*

Section III—Federal Award Findings and Questioned Costs

[This section identifies the audit findings required to be reported by section 510(a) of Circular A-133 (for example, reportable conditions, material weaknesses, and material instances of noncompliance, including questioned costs). Where practical, findings should be organized by federal agency or pass-through entity.]

Identify each finding with a reference number.⁸ If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section

⁵ A suggested format for assigning reference numbers is to use the last two digits of the fiscal year being audited, followed by a numeric sequence of findings. For example, findings identified and reported in the audit of fiscal year 20X1 would be assigned reference numbers of 20X1-1, 20X1-2, etc.

⁶ Provide sufficient information for judging the prevalence and consequences of the finding, such as the relation to the universe of costs and/or the number of items examined and quantification of audit findings in dollars.

⁷ See paragraphs 5.18 through 5.20 and 7.38 through 7.42 of *Government Auditing Standards* for additional guidance on reporting management's response.

⁸ See footnote 5.

III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a finding of noncompliance with a federal program law that is also material to the financial statements would generally be reported in detail in this section. Section II would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:

- *Information on the federal program*⁹
- *Criteria or specific requirement (including statutory, regulatory, or other citation)*
- *Condition*¹⁰
- *Questioned costs*¹¹
- *Context*¹²
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*¹³

⁹ Provide the federal program (CFDA number and title) and agency, the federal award's number and year, and the name of the pass-through entity, if applicable. When this information is not available, the auditor should provide the best information available to describe the federal award.

¹⁰ Include facts that support the deficiency identified in the audit finding.

¹¹ Identify questioned costs as required by sections 510(a)(3) and 510(a)(4) of Circular A-133.

¹² See footnote 6.

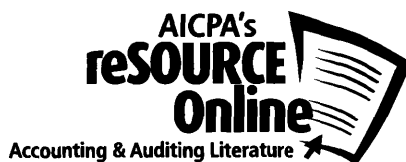
¹³ To the extent practical, indicate when management does not agree with the finding, questioned cost, or both.

APPENDIX F

Schedule of Changes Made to *Statement of Position 98-3—May 2002 Version*

<u>Reference</u>	<u>Change</u>
Note	Revised to reflect the issuance of new accounting and auditing standards and to give Web site addresses.
Summary	Revised to reflect that there are annual updates to <i>OMB Compliance Supplement</i> .
Paragraph 1.1 (footnote *)	Added to reflect the issuance of SAS No. 95.
Paragraph 1.2 (footnote *)	Revised to reflect the issuance of SAS No. 95.
Paragraph 1.7	Revised to reflect the issuance of new auditing standards.
Paragraph 1.9	Footnote * added to reflect the issuance of SAS No. 95; Reference deleted to <i>Audits of Colleges and Universities</i> because the auditing guidance in that Guide is no longer applicable; Footnote 5 deleted due to deletion of reference to <i>Audits of Colleges and Universities</i> in paragraph 1.9.
Paragraph 1.13 (footnote *)	Added to reflect the issuance of Amendment No. 3 of <i>Government Auditing Standards</i> .
Table 1.2	Revised to reflect the effective date of SAS No. 94.
Paragraph 2.3 (footnote *)	Revised to reflect the issuance of Amendment No. 3 of <i>Government Auditing Standards</i> .
Paragraphs 2.11 and 3.8 (footnotes *)	Added to reflect the issuance of Amendment No. 3 of <i>Government Auditing Standards</i> .
Paragraph 3.20 (footnote *)	Added to reflect the issuance of SAS No. 96.
Paragraph 3.24	Revised title of Auditing Interpretation due to issuance of SAS No. 96.
Paragraph 3.35	Reference deleted to <i>Audits of Colleges and Universities</i> because the auditing guidance in that Guide is no longer applicable; Footnote 5 deleted due to deletion of reference to <i>Audits of Colleges and Universities</i> in paragraph 3.35.
Paragraphs 3.43 and 3.45 (footnotes *)	Added to reflect the issuance of Amendment No. 3 of <i>Government Auditing Standards</i> .
Paragraph 3.52 (footnote *)	Added to refer to PCIE desk review and quality control review guides.
Paragraph 3.54 (footnote *)	Added to reflect the issuance of Amendment No. 3 of <i>Government Auditing Standards</i> .

<u>Reference</u>	<u>Change</u>
Paragraph 4.6 (footnote 2)	Revised to clarify that the footnote relates only to the accounting guidance in <i>Audits of Colleges and Universities</i> , and that the Guide only applies to entities that have not adopted GASB Statement Nos. 34 and 35.
Paragraphs 4.9, 4.10, 4.11, 4.13, and 4.15	Revised to reflect the effective date of SAS No. 94; Footnotes * deleted.
Paragraph 4.16	Revised to reflect the effective date of SAS No. 89; Footnote ** deleted.
Paragraph 4.35	Revised to reflect the issuance of SAS No. 95.
Paragraph 4.39	Revised to reflect the effective date of SAS No. 94; Footnote * added to reflect the issuance of SAS No. 96.
Paragraph 4.40d	Revised to clarify guidance.
Paragraph 7.31	Revised to clarify guidance and to reflect the guidance in SAS No. 55, as amended.
Paragraphs 8.6, 8.7, 8.10, 8.15, 8.18, and 8.23	Revised to reflect the effective date of SAS No. 94; Footnotes * deleted.
Paragraph 8.27 (footnote *)	Added to reflect the issuance of SAS No. 96.
Paragraph 9.26	Revised to be consistent with the <i>Compliance Supplement</i> .
Paragraph 10.13 and footnote 2	References deleted to <i>Audits of Colleges and Universities</i> because the auditing guidance in that Guide is no longer applicable.
Paragraph 10.27	Revised to reflect the effective date of SAS No. 94; Footnote * deleted.
Paragraph 10.68	Sentence deleted due to revisions made to Data Collection Form (new question 8 in Part III now asks whether a Summary Schedule of Prior Audit Findings was prepared).
Appendix C, Example Entity University Schedule of Expenditures of Federal Awards (footnote *)	Added to clarify that the schedule or the notes thereto should include certain Department of Education pro- grams (FFELP and Direct Loan Program) to the extent an entity participates in them.



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